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Church Development Service
An Association of the Protestant
Churches in Germany

Foreign Direct Investment

High Risk, Low Reward for Development

An Accompanying Civil Society Report
to the World Development Report 2005
A Better Investment Climate for Everyone

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Dear Reader,

Churches are a vibrant part of Civil Society worldwide. They are faith-based organizations of people. Bearing witness is their vocation. Therefore, the Protestant Development Service (EED), an Association of the Protestant Churches in Germany is involved in important development questions. And could there be a more pertinent question regarding development than that as to how it is to be financed?

Finance questions are everywhere contentious. Livelihood, future and fate depend on them. Policies and structures carved out at a global level by IMF, the World Bank or the WTO, become part of the mindsets of policymakers worldwide. They tend to be implemented in adapted forms, again and again. Questions of the global finance architecture are most important for the development of poor people in poor countries. Policy makers in the IMF, the World Bank and elsewhere should not be left alone with the responsibility of responding to them. Their views will remain incomplete without the integration of the experiences and perspectives of the global Civil Society.

Is it true that »A Better Investment Climate for Everyone,« as the title of World Bank's World Development Report 2005 suggests, will do the trick? That creating better investment conditions for firms will bring about economic growth? Is it acceptable that Foreign Direct Investment has been given little consideration in the World Development Report 2005. How can the »race to the bottom« of labor, environmental standards and taxes among countries competing for foreign investment be halted?

The Protestant Development Service promotes a multitude of projects with over 3000 partners in more than fifty developing countries. It also accompanies the multilateral policy-making process, e.g. regarding global trade and finance questions of the poor from a civil-society perspective. It does this together with its partners in the Ecumenical Movement of Churches and with specialized partner organizations in many countries. Together with these it opts for regulations on foreign investment that are global, monitored by a multilateral institution and equipped with a mechanism for sanctions.

I would like to take this opportunity to thank the organizations and authors of this EED-Report on Foreign Direct Investment for their enlightening contributions. I cherish the hope that the report will help Civil Society Organizations and policy makers to offer their Governments and national representatives of Multilateral Institutions critical orientation when Pro Poor Policies are to be adopted regarding Foreign Direct Investment.

Wilfried Steen

Wilfried Steen, Policy Director , EED

1. Executive Summary

This Civil Society Report is a critique of the World Development Report 2005 A Better Investment Climate for Everyone (WDR 05). It emphasizes on Foreign Direct Investment (FDI, see Chapters 2—8) because the Monterrey Consensus expects FDI to play a major role in solving the problem of the lack of funds for achieving the Millennium Development goals. The World Bank supports these FDI expectations through its active development policies. Surprisingly however, FDI is given very little attention in the WDR 05. FDI was also chosen as a focus because of the leverage it has on the macro-economy of a country.

The report takes up some of the basic macro-economic, historical and spillover-related questions concerning FDI (see Chapters 2, 3 & 4). It takes a closer look at them in two specific sectors of the economy: a) the natural-resources sector, and in particular in the oil industry; and b) in the financial services sector (see Chapters 5 and 6). Most importantly, in order to obtain a differentiated picture, it includes two studies of FDI country situations: one on Bangladesh and one on Brazil (see Chapters 7 & 8).

The Civil Society Report on Foreign Direct Investment and Poverty Reduction has the following findings:

- No doubt greenfield investments are better then portfolio speculation. However, even this relatively benign type of FDI can upset a Balance of Payment, when forex outflow obligations accumulate over time. Bangladesh e.g. has been a net capital exporter in 2003, Brazil will have to observe and differentiate its in- and outflows in order to raise alarm should accumulating FDI outflows threaten to deepen the BOP crisis.
- There exists a basic contradiction between the goal of poverty reduction on the one hand and investor demands for lower taxes, lower wages, less regulation and privatization of basic services on the other.
- FDI does not automatically generate positive spillovers. Whether or not these take place depends on local conditions and the ability of the host country to regulate and tailor FDI inflows.
- FDI leads to net capital outflows in the long run. If capital import does not generate sufficient foreign exchange to service foreign exchange obligations, the country will inescapably be at risk of a balance-of-payments crisis.
- Historical evidence demonstrates that tight regulations on FDI did not, for instance hamper the development of the US to an economic super power—on the contrary: regulation of FDI was an important condition, not to say a requirement, for ensuring positive effects on its economic development.
- Investment competition is often connected to harmful tax competition which erodes the tax base of the state and prohibits necessary investments in infrastructure (see Chapter 5).
- FDI, if connected to the privatization and the sale of public utilities tends to contribute to poverty, since foreign investors have no interest in maintaining a costly infrastructure for the poorer segments of society.
- FDI is especially problematic in strategic industries. The best example may be the oil industry, which is dominated by powerful TNCs such as Exxon, Shell, BP, etc. Another example is the financial sector where the entry of foreign banks and insurance com-

panies is often associated with a reduction of credit for small enterprises and a destabilization of the local banking system

To sum up: There is no reason to share the high expectations of the Monterrey Consensus, that FDI will contribute the missing resources for poverty reduction. The team of authors could find no automatic link of an improved investment climate for FDI with a reduction of poverty. It is convinced however, that this link can be established by meaningful and global regulation.

The concluding chapter of the report takes a critical look at the WDR 05 itself. It asks the World Bank why, for instance, foreign direct investment has been removed to the backstage, why governments as investors have been neglected, or why so much less research has been conducted into the informal sector than into the formal sector economy? (See Chapter 10)

1.1 The Country Study on Brazil:

Capital flows have played an essential role in the country's inability to grow, but FDI has not been an important cause of problems so far. Financial capital flows have been important, both when they come to the country and when they leave. Two provisos should be added, however. First, the border between the two types of flows (FDI and financial capital) is not always clearly set. Secondly, FDI has not been a major concern so far, from a balance of payments point of view, because for most of the post-war period it has represented a relatively small share of the Brazilian capital account. The last few years may have changed this picture. The huge amount of FDI that was internalized may have created liabilities for the future. That may be difficult to honor in the event of a major external crisis. The conditions under which foreign investment has been helpful have been narrow, and any step towards increasing them should be carefully considered.

The Brazilian experience with FDI has been relatively benign. Foreign investors have been unable to impose any special terms. However, FDI in the recent phase of exchange-rate based stabilization took the form of mergers and acquisitions of private and public domestic enterprises, especially in the context of privatization programs. Hence, FDI in Brazil in the 1990s did not complement, but rather crowd out domestic investment, leaving productive capacities almost unchanged and reducing the access of socially deprived groups to such formerly publicly distributed services as electric power. Thus, the factors that made the presence of FDI in Brazil mostly benign may be at the brink of exhaustion. Today, renewed attention must be given to its risks and to the need to consider its role carefully.

The bottom line of the argument developed is: a) Policy makers may not depend on FDI, but rather must perceive it as a complement to domestic public and private capital, available if the state of economic development permits; b) They should plan it within the framework of a well-defined industrial policy; c) If foreign financial resources are needed, FDI is preferable to portfolio investment or to bank credit, albeit with the necessary precautions for dealing adequately with it; and d) Societal organizations in the country must be strengthened to keep up political pressure on foreign firms to behave according to the interests of the society in which they are striking roots.

1.2 The Country Study on Bangladesh:

Despite generous incentives, packages and a policy targeted toward an improved investment climate similar to the WDR 05 recommendations, FDI has failed to play any prime role in employment generation in Bangladesh. The annual repatriation of profits, dividends and royalties which in recent years even surpassed net FDI-inflows, has increasingly placed pressure on the balance of payments. Hence, the experience in Bangladesh shows that FDI has not decisively contributed to reducing the two key weaknesses of a Least Developed Country: high unemployment and widespread poverty, coupled with a scarcity of foreign exchange. Bangladesh has become a net exporter of capital.

To attract FDI, Bangladesh has to reinforce its infrastructure facilities and improve the quality of its service. Furthermore, a consistent incentive packages should be implemented which may include rationalization of para-tariffs, elimination of non-tariff barriers, reduction in interest rates, access to financing and the enhancement of competitiveness through capacity building, etc. To encourage foreign investors to invest in Bangladesh, the domestic investment rate should be increased, a measure closely related to the improvement of the business environment and economic governance.

An LDC like Bangladesh needs to develop and facilitate its negotiating capacity on the multilateral stage, in order to protect its own interests. There are strong arguments in the country against unrestricted activity for FDI and equal treatment for foreign investors compared with domestic producers; one fears the loss of control over quality and quantity of foreign investment, the threat of a deepening BOP crisis, suspension of domestic support policies for the weak and priority sectors, reduced possibilities for technology transfer etc. The country also needs to look at investment opportunities within the region. Incremental regional investment complemented by the initiative to build a regional free-trade area may work as a catalyst for attracting extra-regional FDI. In fact, FDI may emerge as an economically integrating force in South Asia.

Interventions for pro-poor growth and fostering income equality could result in a greater impact on poverty reduction. In this context, the author suggests seven principles for »good« FDI (see Chapter 7, page 63).

To realize the positive impact of FDI, it is necessary that governments retain the right to choose the types and direction of FDI according to their own needs. Last but not least, good governance is crucial to ensuring the increased flow of FDI and thereby sustaining pro-poor economic growth.

1.3 FDI Requires Global Regulation

From a Civil Society point of view, it is necessary to take stock of developmental risks involved with FDI and to define conditions under which foreign investment is not socially and environmentally harmful (see Chapter 9). With respect to development goals the most damaging of all the risks identified in this Civil Society Report are: (1) increasing foreign indebtedness; (2) reduced national debt-service capacity; (3) reduced access to financial and social services for the poor; (4) enforced income concentration; (5) down-sizing of working and environmental conditions; and last, but not least (6) reduced national sovereignty to pursue developmental policies. To put it positively, FDI must conform to specific criteria in order to have a net positive impact on the host country and especially on the achievement of the Millennium Development Goals (MDGs). Some of these criteria are: (1) improving the external position of developing countries (which are net foreign debtors); (2) showing a counter-cyclical effect, or at least being neutral to typical boom-and-bust-cycles induced by such other financial flows as traditional credits or portfolio investment; (3) generating net employment opportunities for the local workforce; (4) increasing the value-added by capacity building of the local workforce, technical up-grading of processing procedures and enforcing forward and backward linkages, especially with SMEs; and (5) maintaining the environment and preserving biodiversity.

Both voluntary codes of conduct and bilateral investment treaties have in common the considerable weakening of multilateralism. Hence, a reasonable regulation of FDI to give developing countries a decent chance to benefit from FDI inflows must be compulsory on a multilateral level. They must be subject to special and differential treatment according to the desired impact on the host country, and abide by a transparent and binding sanctions mechanism.

1.4 A Multilateral Institution like the ILO Should Be the Agent

Given its trade liberalization agenda and the dominance of the major industrialized countries, the World Trade Organization (WTO) is not an appropriate forum where to negotiate and agree on such a global regulatory framework. Other international arenas that are dominated by the industrialized countries (such as the World Bank, the IMF or the OECD) likewise lack the legitimacy and neutral policies to deal with the regulation of FDI in a developmental way, too. UNCITRAL would provide the neutral grounds of the UN-Charter.

Among the existing international organizations, the ILO therefore seems best suited as an international regulator of FDI, using as a basis UN-standards and declarations (like on sustainable development, human rights, poverty eradication etc.) and the ILO Core Labor Standards. The tripartite character of the ILO guarantees that labor, in addition to government and industry, is an integral part of the process. In future however, it should also include a mechanism to provide Civil Society with a procedure for raising objections to investment.

2. Introduction*

»Private firms—from farmers and microentrepreneurs to local manufacturing companies and multinational enterprises—are at the heart of the development process« (World Bank 2004: 1).

This is one of the first sentences and the overarching hypothesis of this year's World *Development Report 2005—A Better Investment Climate—for Everyone* published by the World Bank.

In a nutshell, the *World Development Report's* underlying assumption is that states and Governments must only correctly »condition« their domestic investment climate to stimulate private investment and growth, and thereby automatically bring about development and poverty reduction. This Civil Society Report questions any automatic link between investment climate and reduction of poverty, for several reasons.

Let us *first* shed some light on the link between the investment climate and actual investment. The main motivation for the private sector to invest is the expectation of earning a financial return that will not only permit a recouping of the initial sum of investment, but will also generate an additional profit. Nobody will invest without the prospect of receiving of the fruits of this investment. Accordingly, property rights, rule of law, a well-functioning public administration, reliable physical infrastructure and security are favorable conditions for investment, as they reduce the expense and effort companies face when carrying out investments. However, the key inspiration driving investment is not minimization of cost, but rather maximization of profit. If there are no sufficient expectation of future earnings, the investment will not be carried out, no matter how good the investment climate may be. Obviously, just offering a »good« investment climate is insufficient to stimulate domestic investment and attract foreign investors.

Secondly, an improvement of conditions for private investment is not free of cost to society. A deregulation of labor standards might increase profits, but at a cost to workers. And lowering taxes will seriously harm those who depend on such public services as education, health services, drinking water and other public infrastructural services. A better investment climate can contribute to more private investment, but there is no corollary. A strategy heading for a »better« investment climate for investors only will almost certainly put some other parts of the society into a worse situation than they have previously been. Trade unions, social movements, Churches and Non-Governmental Organizations (NGOs) strongly object to the »improvement« of investment conditions by simply reducing regulation and lowering standards. They have voiced strong concerns that such investment-favoring policies can trigger a »race to the bottom« in social and environmental achievements and standards. They also object to the allocation of disproportionately high shares of Government revenues to investment-favorable infrastructure, as this almost always occurs at the cost of social services. They do not however, object to attempts to reduce corruption and improve governance, although their motivation here may not necessarily be primarily a wish to improve the investment climate.

Thirdly, the risk of a race to the bottom is especially acute when it comes to attracting investment across borders. Under conditions of liberalized financial markets, investors have

* For references to Chapters 2,3 and 4, please see p. 32

the choice in which country to invest. Therefore, the issue of improving the investment climate is about the relative incentives to invest in one country rather than another. And that risk is especially implied by the activities of globally operating transnational corporations (TNCs) which, due to their market power, are often rule-setters rather than rule-takers, as for instance domestic small and medium enterprises or firms operating in the informal sector would be. Any strategy of improving the domestic investment climate that does not operate on the basis of extremely attractive markets or scarce raw materials is about offering a better climate at home than in competing locations abroad. And this implies offering more favorable conditions for investors to boost their profits in the domestic market e.g. by lower taxes, lower wages, better and cheaper infrastructure, lower levels of social and environmental regulation and more direct and indirect subsidies than those prevailing in other countries.

Obviously, not all countries can have a better investment climate than other countries. Any strategy for improving the investment climate necessarily aims at attracting investment at the cost of less investment somewhere else. Of course, this is not just a zero-sum game, since a general improvement in investment conditions will broaden the set of profitable investment opportunities altogether and might therefore also trigger more real investment. But the balance sheet of the provision of such benefits as tax holidays on the one hand, and the actual amount of additional investment they attract on the other, can be very unfavorable from a broader societal perspective. In fact, a better investment climate often simply expands the profitability of potential investments at the cost of other economic actors (e.g. wage earners, users of public social services etc.).

Fourthly, if assuming that a better investment climate actually triggers additional private investment, this is by no means a guarantee for »more« development and less poverty. The only causal link that can be reasonably established from the point of view of the economy as a whole is that a higher level of investment in absolute terms can lead to higher growth rates. There has been a long political and academic debate over the extent to which growth contributes to poverty reduction. Those academics and politicians who adhere to the trickle-down thesis argue that growth is like a tide that lifts all boats, large and small alike. The trickle-down thesis which had been a dominant component in development theory till the 1970s assumes that societies would grow out of poverty phoenix-like if economic growth were only high enough and the growth process has sufficient dynamism.

But the experience of the last fifty years of development history has shown that growth has often been accompanied by even more poverty and a worsening distribution of income and wealth. If large parts of society are excluded from the growth process—for which the phenomenon of jobless growth may serve here as a noteworthy reference—economic growth will not increase the chances for reducing poverty. Furthermore, economic growth gives Governments room to maneuver in favor of poverty reduction only if (a) they have access to the financial resources in the form of taxes and social security contributions generated by successful investments; and if (b) they understand poverty reduction as a core public responsibility.

The *World Development Report 2005* rejects both, by recommending widespread tax reductions and assuming that poverty reduction will be a by-product of private investment.

These recommendations of the World Development Report have inspired this Civil Society Report to address the link of investment, development and poverty reduction from a civil-society and social-movement perspective. Like the World Bank in its rhetoric, the concern of the Civil Society Report is development and poverty reduction that benefits the majority of poor people in developing countries. Unlike the World Bank, it does not see these objectives as being well pursued by a focus on investment climate and private investment per se.

On the contrary, private investment is only one particular form, and must be accompanied by public and community investment. And any investment has to be framed by development-oriented multilateral and national policies to achieve poverty reduction. States and multilateral political arenas need to carve out regulatory frameworks for investors, in order to make their investments work both for growth and for poverty reduction.

Foreign Direct Investment

There are several sets of questions linked to private investment and poverty reduction that are missing in the WDR. For instance, the report hardly addresses the central role of the State as a major economic actor in developing countries. The State provides functions such as (1) improving investment conditions to facilitate more successful private investment; (2) redistribution through access to clean water and sanitation, or provision of sufficient housing and free education for the poor so that basic needs even of those individuals are satisfied who are excluded from the private-sector-based investment process; and (3) investing on its own in physical infrastructure thereby improving private investment conditions and offering jobs for the excluded.

The *World Development Report* sidelines this role of the State. Those searching for more differentiated contributions on this sensible issue in times of liberalized markets with higher vulnerability for the economies involved and eroding public financial resources will be frustrated after having read the 250 pages comprising the current WDR.

As a consequence of the negative experiences with loans and portfolio-investment during the debt and financial crises of developing countries during the 1980s and 1990s, there was considerable appreciation by official development think tanks such as the International Monetary Fund (IMF), the World Bank, the Organization for Economic Cooperation and Development (OECD) and the United Conference on Trade and Development (UNCTAD) for the role of FDI in fostering growth and development.

This increasingly optimistic view of FDI and its development impact is reflected in the »Financing for Development« (FFD) process and its concluding result, the »Monterrey-Consensus,« of which the World Bank was among the main protagonists. The Consensus, established in the final document of the »International Conference on Financing for Development« held in Monterrey in March 2002, identified a crucial role to be played by FDI to finance development in the South in the future:

> *»Foreign direct investment contributes toward financing sustained economic growth over the long term. It is especially important for its potential to transfer knowledge and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship, and ultimately eradicate poverty through economic growth and development. A central challenge, therefore, is to create the necessary domestic and international conditions to facilitate direct investment flows conducive to achieving national development priorities to developing countries, and particularly in Africa, least developed countries, small island developing states, and landlocked developing countries, and also to countries with economies in transition.«*[1]

This new view on FDI, however, was clearly criticized by trade unions, social movements, churches and NGOs. There is no proof that the track record of FDI would be better only because it was acknowledged towards the end of the 1990s that loans and portfolio investment have led many development countries deeper into economic crisis and debt. FDI may have even as strong a negative balance-of-payments effect as loans and portfolio investments have been shown to possess.

Moreover, as stated above, increased competition for FDI can easily spark a »race to the bottom« that undermines developmental and environmental achievements. Furthermore, the experience of the 1990s shows a high pro-cyclicity of FDI which enforced the notorious boom-and bust cycles.

Although with this *WDR 05*, the World Bank is carrying out a task assigned to it by the Monterrey Consensus, it disregards that Consensus in two ways. Firstly, it is somewhat surprising that the *WDR 05* attributes so little explicit importance to FDI, and makes scant distinction between domestic and foreign sources of investment. The *WDR 05* generally speaks of investment, investors, firm and entrepreneurs, but only in very few cases does the report explicitly deal with the different implications of domestic and foreign investment.

Secondly, the World Bank places strong emphasis on national policies rather than the multilateral level to facilitate investment: »Responsibility for improving society's investment climate lies with the governments of developing countries, both national and sub-national« (*WDR 05*: Overview: 70)[2]. The international community can only »lend a hand« (ibid). Nonetheless, hereby the World Bank clearly disregards the Monterrey-Consensus's attempt to balance the need of policy reformulation between the national and the international level.

To sum up, the *WDR 05* fails to give much attention to the particular characteristics of FDI when addressing the issue of investment climate. It ignores the significantly different implications that domestic and foreign sources of investment can have, and thereby makes a decisive mistake. In its policies, the World Bank always advocated a (profit-) friendly environment for foreign investors, often at the cost of national industrial policies, and sometimes, too, at the cost of the interests of domestic companies. It is noteworthy that the World Bank did not use the *WDR 05* to aggressively repeat its liberalization credo with regard to FDI.

Throughout the report we have identified at least four crucial questions to judge the developmental chances of FDI:

- Does FDI complement or substitute domestic investment?
- Is FDI integrated in and does it foster integration with the local economic structures?
- Does FDI strengthen or weaken the political range of options of the host country to levy taxes and pursue industrial policies?
- Is the long-term net financial outflow through FDI compensated for by the contribution which that investment makes to the balance of payments?

This introduction is not the place to draw conclusions. However, it is pertinent to highlight the main hypotheses that we seek to evaluate in the following chapters:

Firstly, when judging FDI as a source of investment, one must differentiate between FDI in competition with a) other foreign sources of investment (such as portfolio investment and loans); and b) domestic sources of investment. Depending on the object of comparison, the conclusion can differ considerably.

Secondly, FDI can contribute to development only if it is embedded in a developmental framework. Such a framework must, for example, give countries room to pursue their own industrial policies. To allow for that, the scope for national investment policies needs to be framed by global rules. Without such rules for global FDI we could easily end up in a race to the bottom, through ruinous competition for globally limited FDI—which would neither help growth nor reduce poverty.

[1] Final Outcome of the International Conference on Financing for Development, page 5, Paragraph 20.

[2] Another quote from Chapter 10.1: »Improving the investment climate of their societies is first and foremost the responsibility of Governments.«

3. Investment, Development and Poverty – Some Remarks

Philipp Hersel

Development is a broad and highly controversial concept. Though there exists a set of factors that are frequently co-notated with development (e.g. typical economic features like a rise in per capita income and a higher level of employment, or factors from the Human Development Index of the UNDP, like higher levels of education, a rise in health and life expectancy, decreasing child mortality etc.), there is no consensus as to what exactly constitutes development. However, whether one is concerned with industry, agriculture, or infrastructure, from a development economics point of view it is fairly safe to stress the role of investment for development. Any means of production that cannot directly be found in the natural environment implies that at some time in history human beings transformed given materials by labor into a tool to help them produce things to improve their lives. When our ancestors invented the hoe, they did so by »investing« their labor into transforming wood and/or metal in a manner that would help them to cultivate land. After having invented the hoe, they spend many hours simply reproducing this invention to get more and better hoes to replace old and broken ones. Accordingly, investment is about inventing, applying and reproducing technology. Furthermore, it is about accumulation. Hoes get worn out over time; therefore, one needs to replace them periodically. If the number of hoes is the stock of capital in an economy, this stock will obviously deteriorate if worn-out hoes are not replaced. Accumulation of capital in a society only takes place if more means of production valued in current prices are added to the capital stock than have disappeared due to deterioration during the same period. Finally, only a rising stock of capital[3] is capable of providing future generations with more products than we have today. Economists term this phenomenon »growth.«

> *Economic growth is positive when investment exceeds the amount necessary to replace depreciated capital, thereby allowing the next period's cycle to recur on a larger scale.* (Ray, 1998: 54)

Obviously, investment plays an important role in the process of economic growth. Yet, as pointed out above, growth itself is not a sufficient condition for development. For investment to promote development, investments must have direct and indirect positive impacts on the people's lives. Some positive consequences of investments for people are increasing employment, reliable income, increased levels of literacy, life expectancy and health, better-quality goods and services on the market, improved public services and participation in social and political life etc. Furthermore, such improvements must not be traded off by related inverse effects elsewhere[4]. If, by investing in location A, five jobs are created at the cost of losing ten jobs at location B, there is serious doubt that this investment has made an overall contribution to development. Of course, the standard argument is that location B was obviously not competitive, and that the ten jobs would have been lost sooner or later

[3] Of course, a rising population can also produce more products with a stable stock of capital, but for the time being we assume no population growth.

[4] In fact, if we consider wealth and development on a global scale (which should be the focus of our analysis), we must take into account not only inverse effects on the lives of people within the same economy/country but we should also consider the consequences and trade-offs in other parts of the world.

anyway. But there are many instances where companies—especially transnational corporations—shift their production sites from one location to another, simultaneously downsizing their workforce, saving on taxes and increasing their rates of return (for details see Chapters 4.5 and 6).

To obtain a proper picture of the relation between investment, development and poverty reduction, we must overcome the tendency to treat investment as the abstract sum of resources spent on producing means of production. As long as the entire capital stock of an economy consists of hoes, the story is rather simple. But in today's world, the abstract term »investment« takes the form of very diverse concrete investments: manufacturing machinery, building houses and roads, research and development, etc.

As a matter of fact, the ultimate purpose of the entrepreneur in a capitalist economy is to make profits. This is not only his/her individual goal, but rather the systemic function of capitalism that private capital accumulates by generating incomes exceeding its costs, i.e. making profits. Thus blaming capitalists for seeking only to optimize their profits is like blaming cats for catching mice. However, investors differ significantly in size—from self-employed individuals to huge conglomerates; in what they produce; and in ability to alter the conditions of their investments, i.e. by influencing political decisions on taxation, property rights, wages, standards, education etc. Coming down to the practical side, we have to take a closer look at some aspects of investments and investors in their diversity.

3.1 Investment to Produce for Local or Foreign Demand

One important criterion in which investments differ is final demand. Does production offer goods and services for domestic or foreign demand? Taking Zambia as an example, the impact on the domestic economy will be very different if on the one hand, a local entrepreneur builds a bakery to produce for the local market, or if, on the other, a large corporation sets up a mining-site to extract copper for export. Both investment will generate employment and pay wages to workers. However, whereas bread always feeds people, copper only becomes valuable for the domestic economy if it is either profitably exported and the proceeds are spent to raise the living standard of the population, or if it is processed to cable and pipes to distribute and deliver energy and water. However, developing countries, particularly low-income countries, hardly have the opportunity to process raw materials themselves.

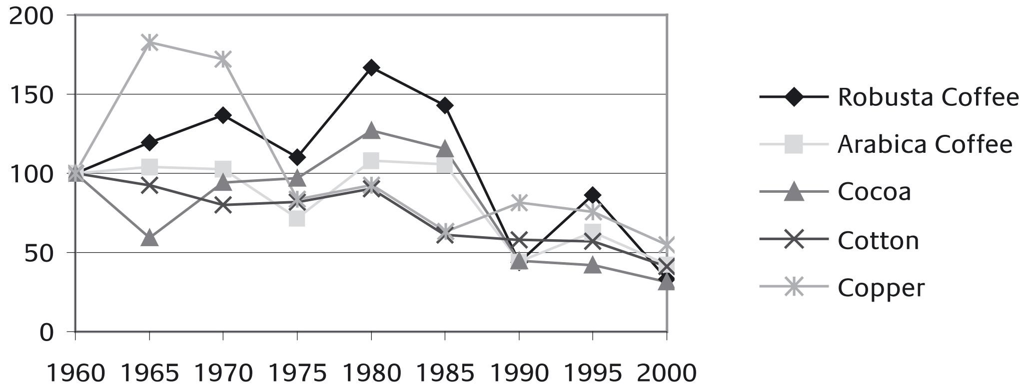
On the one hand, there is often a lack of technological facilities in the country to do so, on the other, the setting up of a cable and/or pipe production only makes sense if production can take place at a sufficient scale. Production only for the local market would therefore hardly be profitable, accordingly production for export would be necessary. Here, however, the international trading system tends to discriminate against processed products. Industrial countries like the US, Japan and the European Union generally use tariff hikes to discourage countries with raw materials from processing them into finished goods themselves. This system contributes to keeping many raw-materials-endowed developing countries as providers only of primary products, rather than becoming exporters of processed goods. Investment in production for foreign demand, particularly in low-income countries, is therefore very often associated with export agriculture and extractive industries.

If the domestic added value of copper exports (e.g. the wages of local workers per unit of exported copper ore) is comparably lower than the foreign added value of imported cables or pipes (e.g. the wages of foreign workers abroad per unit of imported cables or pipes), then Zambia looses potential income by exporting copper ore and importing cables and pipes. In this particular case, the copper extraction will furthermore reduce the stock of natural resources of Zambia and is also likely to compromise the local environment, whereas the bakery will be less of a threat to the environment.

In addition to the missed opportunities of added value in the export of primary products, there is the problem of uncertain or falling commodity prices. The prices of many raw materials and agricultural products, such

Fig 3.1: Prices of selected raw materials (1960-2000) (1960 = 100)

Source: World Bank 2001: 330



as cotton, copper, coffee or cocoa, have experienced dramatic volatility and decline in the last decades (see Chart).

Summing up, investments to produce only for exports in sectors of primary goods can hardly ever be the driving force of development and poverty reduction; rather, they tend to perpetuate underdevelopment.

Source: World Bank 2001: 330

3.2 Size of Investments, Employment and the Role of Technology

Investments also differ in their appeal to different potential investors and in their impacts on distinct consumer groups. Historical experience has shown that microcredit schemes can help to finance small and medium-sized local investments that generate profits on an equal or even higher level than large-scale investment projects in extractive industries. Similarly, the positive impacts on the lives of people differ dramatically between investments in appropriate technology to be employed by small and medium size enterprises (SMEs) on the one hand and high-tech mega projects, mainly affordable only for large and often transnational corporations. The former will generally create relatively more jobs and often help to form clusters of domestic firms that compete in innovations. SMEs tend to integrate larger parts of the society into the economy, and to offer goods and services that are affordable to the lower strata of society.

Coming back to our example, when comparing the value of the final products, the bakery will probably spend more on wages than the copper-extraction site. Thereby, locally baked bread directly and indirectly (by paying wages) better helps to feed local people. Large scale industries like the oil or mining sectors (particularly in developing countries) often only produce for export, and offer relatively few jobs to local people relative to turnover. Of course, earnings from copper exports can be used for imports for domestic purposes, too. But the import intensity of such investments, particularly if implemented by foreign investors, is relatively high, which uses up parts of the scarce foreign exchange generated. SMEs on average are far less import-intensive and put far less pressure on scarce foreign exchange resources of developing countries.

However, SMEs are often part of the informal sector, pay low wages and offer only very limited job security. High-tech and large scale projects, on the other hand, more often end up as technology islands in the middle of nowhere, hence, without forming the necessary chains to local suppliers, so that their role in technology transfer is often very limited, and their contribution to the evolution of a sustainable industrial structure is marginal. Nonetheless, wages and working conditions for workers directly employed in these islands are often better than in other parts of the domestic economy. To make large and technology-intensive firms valuable for the economy as a whole, it is important to establish linkages and spillovers between these large firms and SMEs, e.g. by forming integrated chains to local suppliers, and by fluctuation of employees to spread knowledge.

3.3 Public, Private and Community Investment

One of the major differences in the realm of investment is between public and private investment. Public investment generally provides the infrastructural environment of a functioning society and economy. There is hardly any disagreement about the fact that public bodies have to undertake essential investments in infrastructure, such as roads, schools, hospitals and other facilities. Even from a fundamentalist open-market position, public investment is inevitably in all cases where the economic benefits from such investments (e.g. a well trained and healthy workforce, reliable roads for quick, safe and cheap transport, etc.) are dispersed throughout the entire economy (so-called »externalities«). Such investments, in sum, may generate indirect profits at the level of the whole economy, but these benefits cannot be attributed to a single beneficiary.

Inspired by the assumption that investment which results only in indirect profits for the whole economy is generally poor, badly managed and not cost-effective, mainstream economists argue in favor of »privatization« and, as a means toward that end, »commercialization« of services such as education, local transport, proliferation of water, sanitation and energy etc. To profitably sell basic education and health or local mobility as a commodity on the market, such investments must become directly profitable at the microeconomic level (e.g. by introducing fees for schools and universities, deriving earnings from hospital treatment, or imposing tolls for road use). A commercialization of social services results in an increased concentration of income: Those individuals who, due to their higher incomes, are able to afford privately provided social services, are better educated, healthier and more mobile, and therefore have access to even better and higher-paid jobs. Hence, a commercialization of social services further strengthens the concentration of income in developing countries where income disparities are very high in any case. Any policy aiming at equality of opportunity and social justice should therefore rule out such a commercialization of social services and infrastructure.

Particularly poor people benefit from essential public services, e.g. a drinking water supply system for the local population. Therefore, when the developmental and poverty reduction impacts of investment is examined, public investments should be the central focus of the investigation. However, in the WDR, public investment only occurs as a precondition for private profits. Accordingly, although it is important as a means of improving the conditions under which private investment could be more successful, public investment in social and physical infrastructure must not be subsumed under the single-minded goal of realizing direct profitability in the short run for private investment.

Certainly, not all public investment is biased in favor of the poor. India, for example, is known for offering excellent higher education, but spends relatively little on primary education. This is a form of public investment which is not focused on the provision of goods and services to satisfy basic needs. Children from rich families have in general substantially higher chances to finish primary and secondary school. But if basic education is not provided for all children, the set of students entitled to enter university reflects a social selection not based on competence and skills, but on income and wealth.

One of the often neglected forms of investment is undertaken by communities, e.g. when farmers invest in and share common agricultural machinery, seeds and land, or when communities own and sustain their property in common rather than as individuals. Communal or cooperative investment is of high relevance to rural and particularly indigenous communities. It forms the basis of social organization and survival for millions of people, and must not be neglected when considering the role of investment for poverty reduction at the local level.

3.4 Domestic and Foreign Investors

The distinction between domestic and foreign investors must be separated from the question as to whether production is to be for domestic or foreign markets. However, since foreign investors bring with them experience with foreign markets, and want to integrate production sites in developing countries into their global production chains, many foreign investments tend to produce largely for the global market.

The major difference between domestic and foreign investors concerns the balance of payment. Foreign capital comes into the country in foreign currency and, plausibly, foreign investors expect their profits to be remitted from the host country to their home countries in foreign exchange. As investors only undertake an investment if they expect more profits from an investment than their initial amount of investment, successful foreign investment forms the basis of a net financial outflow from the host country in the long run. There are various conditions and side-effects which can compensate this financial flow, and which will be dealt with in depth in Chapter 4.2 and 4.3. However, there are considerable balance-of-payments risks linked to foreign capital inflows which do not accrue from domestic sources of investment.

The central question about foreign investment is whether it complements or replaces domestic investment. If domestic investment is complemented by foreign investment, in other words, if there is additional investment through FDI which would have not been undertaken without FDI, a net positive balance in employment will result. If, on the other hand, local firms are taken over by foreign investors which rationalize and downsize the workforce, the balance of FDI on employment will be negative. The same will apply if foreign subsidiaries out-compete domestic enterprises.

As subsidiaries of foreign firms have direct access to modern technology, management skills, links to the world market and financial resources, they tend to be more productive and more competitive in comparison to domestic companies of developing countries. If spillovers to local firms do not take place on a sufficient scale, subsidiaries will realize a long-term competitive advantage, displacing local competitors who lack the necessary relationships, resources and skills to catch up. Such a situation will tend to increase unemployment, foster concentration of market power, and channel a higher share of the domestic economy's profits into the hands of foreign investors. The possibly higher wages paid to workers at foreign-owned firms will then benefit only a negligibly small part of society.[5]

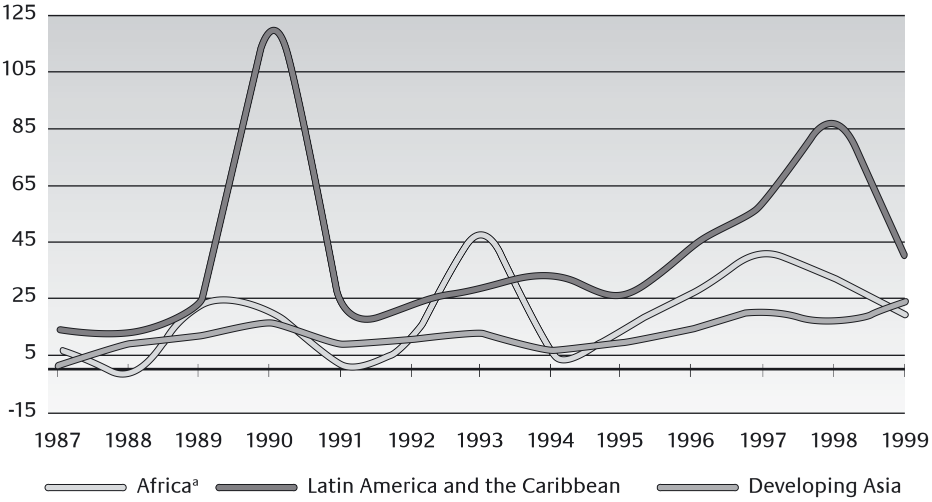
These considerations about the »crowding-out« effects of FDI on the domestic economy are even more relevant, as a large part of overall FDI to developing countries operates either through mergers and acquisitions (M&A), or through privatization. »If China is excluded, the share of M&A in cumulative FDI in 1992-1997 turns out to be 72 per cent, up from 22 per cent during 1988-1991.« (UNCTAD 1999: 118) »Among the developing regions, Latin America and the Caribbean dominate cross-border M&A sales, with Brazil and Argentina as the main sellers. Privatization has been the main vehicle for M&As in both countries.« (UNCTAD 2000:xxii, see Figure below). In the 1990s, Argentina, in accordance with its IMF-structural adjustment programs, privatized almost all its public enterprises. They were overwhelmingly bought by foreign investors, thus substituting former public domestic investment by private foreign investment, shifting property rights to future profits e.g. in the Argentine oil, telecommunication, banking and other sectors to foreign recipients.

Finally, there is another implication of foreign investment that should be addressed briefly. Moving from a national to an international perspective, it rapidly becomes clear that today's reality of FDI flows is hardly characterized by social or ecological rules and standards, which may allow developing countries both to benefit more from FDI inflows and at the same time reduce the risks involved with FDI. After the wave of capital account liberalization of southern countries during the 1990s, the opportunities for foreign investors expanded dramatically, thereby triggering fierce competition between countries to attract foreign investors. The competition for FDI leaves hardly any scope for developing countries to impose

5 See for details of the Mexican example Gallagher and Zarsky (2004).

Fig 3.2: Value of crossborder M&As in relation to the value of FDI inflows in developing countries, by region, 1987-1999

(Percentage)



Source: UNCTAD 2000 (p.17), FDI/TNC database and crossborder M&A database (based on data from Thomson Financial Securities Data Company).
[a] Including South Africa.

restrictions, specific requirements and regulations on foreign investors. Rather, to sustain and enlarge their piece of the global FDI cake, many countries have even started to engage in a competition to offer special sweeteners to foreign investors, such as the exemption from taxation for a considerable period (e.g. ten years), public subsidies and guarantees, and other benefits.

These sweeteners undermine not only the taxation of transnational corporations (TNCs) as economic entities, but also spark similar demands by »domestic« capital. If »equal treatment« in tax exemption and additional subsidies is not quickly conceded, the governments of developing countries are increasingly confronted with the threat of domestic business to shift at least parts of their local production abroad, where they can then benefit from favorable conditions for FDI. Therefore, »sweeteners« designed to attract additional foreign direct investment often result in a reduction of the tax base as a whole, thus reducing public revenues and increasing public expenditure.

4. Foreign Direct Investment and Development

Philipp Hersel and Sebastian v. Eichborn

4.1 Foreign Capital and Development

As pointed out in Chapter 3, economists consider investment a necessary ingredient for achieving economic growth. In economic thinking, the debate about investment is closely connected to the concept of savings.

The Chicken and the Egg: Savings and investment

Saving means not using all income for consumption, but rather saving all or part of it, and thus abstaining from the immediate consumption of all income. As explained with the example of hoes (see Chapter 3), investment historically started by »saving« time (not spending time for »leisure«) by »investing« a certain amount of labor (measured in working hours) to produce, say, hoes as a means of production. In this case, the act of saving and investment is implemented simultaneously by the same person. However, today's economies are far more sophisticated. The division of labor in our societies, with their monetary economies, dictates that households sell their labor to obtain wages as a stream of monetary income, part of which can then be used for savings, and is handed over to firms for investment. This transformation from savings to investment is generally channeled trough banks (»financial intermediaries«) that accept deposits of savers and offer loans to firms. Another channel can be the (partial) acquisition of firms by households (e.g. by purchasing shares), whereby these households become co-owners of wealth. The sum of all goods and services produced in an economy in a particular period equals the overall income of this economy for this period, and is regularly measured as gross domestic product (GDP). Leaving aside taxes and transfers, this income can either be used for consumption or for savings.

A discussion is on-going among economist about the causality between savings and investment. The neoclassical school argues that the cycle of income and consumption starts with an initial act of saving. Accordingly, you need to have income first from which it is possible to save to finance investment and thereby creating production and income. This perspective is countered by the Keynesian approach. Keynesians argue that the neoclassical view might at best be correct for ancient times—as in our example of investment in hoe production. But in today's monetary economies, they argue, investment requires a domestic bank credit to finance new production , thereby generating income e.g. in form of wages and salaries, part of which is then used for savings. Profit, as another part of the income generated by credit-financed investment, serves partially to repay the credit. The latter view obviously attributes a far more influential role to money and banking in the economy.

Markets and Politics in Neoclassical and Keynesian Development Economics

The neoclassical and the Keynesian views stand for two absolute contradictory evolutions of development. According to neoclassical economics, development is mainly a result of the activities of profit-maximizing entrepreneurs and benefit-maximizing consumers, who determine supply and demand in the most efficient way, thus increasing economic welfare. Improvements in investment, capital formation, technology and economic growth etc. can only come about through the activity of private market actors. The more liberalized, open and unregulated an economy is, the broader is the set of incentives for private actors to engage in economic activities. Based on the savings-gap thesis, neoclassical economists recommend a »growth-cum-debt strategy« for development, in which private actors would strategically use foreign financial resources to enhance their domestic investment opportunities.

Keynesian economics, on the other hand, sees development more as the result of a strategy of political and economic intervention, under which guidelines are implemented for private market agents, which influences market processes. Economic development in a Keynesian view is defined as an income-generating process under conditions of macroeconomic stability. Income generation is the result of a credit-financed accumulation process. However, macroeconomic stability is the major condition for a development process, as it alone can insure that the income-generating process is carried out in the domestic currency. Net foreign indebtedness—be it due to loans, portfolio investment or FDI, be it driven by the current account or the capital account—increases dependence on foreign exchange and adds vulnerability of the country. In other words, net foreign indebtedness constitutes a serious setback for economic development and hampers a sustainable catch-up process. Hence, development policy, according to a Keynesian approach, would focus on instruments and measures which tend to reduce monetary instability, increase employment opportunities, reduce debt, employ capital controls, and implement an active trade and economic sector policy.

Without savings, there is a lack of resources to be invested (the neoclassical view). Without investment on the other hand, there is no income which people can save (more or less the Keynesian view). However, even though this argument is still going on (for an overview see Studard 1995), both neoclassical and Keynesian economists stress the importance of savings for the process of investment and development. A considerable part of development-economics literature identifies the lack of savings in developing countries as one of the major obstacles to economic development. Even though this perspective can be seriously questioned (see also Chick 1995), the concept of a »savings gap« is very widespread. The answer provided for the problem of a savings gap is familiar: If there is a lack of savings in their domestic economy, developing countries should resort to tapping additional savings resources from abroad.

There are several ways to do this. First of all, the country can borrow foreign financial resources in the form of loans and credit. Secondly, the country can also allow foreign investors to buy securities on the local markets, e.g. bonds and shares. This type of foreign capital inflows is generally labeled »portfolio investment« and is considered motivated purely by the expectation of financial gain, such as rising stock prices, interest rates on domestic bonds, speculation etc. Only if a foreign investor acquires or owns more than ten percent of a domestic company, is he considered to have a strategic interest in establishing influence over it. This third type of investment is called foreign direct investment (FDI). A very common form of FDI consists of mergers and acquisitions where existing domestic firms are purchased and taken over. Next to mergers and acquisitions financed by foreign capital, there is a second type of FDI: so called »green field investment,« which involves foreign investors setting up new firms and production sites by in a host country.

Box 4.1: Three types of Foreign Capital Inflows

1. Loans (short term and long terms loans and commercial credits from public and private creditors)
2. Portfolio investment (acquisitions of domestic securities like bonds and shares by foreigners)
3. Foreign direct investment (mergers with and acquisitions of domestic firms by foreigners and green field investment)

Loans were the dominating type of foreign capital inflows to developing countries from the 1960s until the early 1980s. The developing countries' debt crises since 1982 and the accompanying economic and social crises in the debtor countries (particularly linked to the »structural adjustment programs«) strongly questioned the developmental benefits of loans as a strategic instrument for development. This applied even more strongly to portfolio investments, which, together with short-term bank loans, were considered to have been responsible, or at least to have fueled, the dramatic financial crises in Mexico, Southeast Asia, Russia, Turkey, Brazil, Argentina and other countries during the 1990s. These financial crises were strongly connected to dramatic reversals in short-term capital flows from the affected countries. Particularly these portfolio investments and short-term bank credits were withdrawn from the crises-afflicted countries at very short notice, leaving them with heavy currency and balance of payments (BOP) problems, causing general economic crises, and undermining the developmental achievements of many years. We will concentrate on the developmental risks of foreign capital imports such as FDI for the BOP and the exchange rate of developing countries in the following sections 4.2 and 4.3

4.2 The Balance-of-Payments Implications of Foreign Investment

Whenever foreign capital inflows cross the border into a domestic economy, they are registered in the balance of payments (BOP), which records all economic interactions between economic agents of the domestic sphere with actors and entities of the rest of the world. As pointed out in the Introduction and Chapter 3, foreign investment has implications on the BOP that domestic sources of investment do not. By contrast to sources of investment denominated in domestic currency, foreign-currency-based investments, such as FDI (as well as investment by domestic companies financed by foreign currency loans), lay the basis for profit expectations and liabilities to repay the loans that accrue in foreign currency: Foreign investors and creditors want to receive their profits remittances, amortization and interest payments in foreign exchange. As developing countries find it difficult to earn foreign exchange, it is necessary from a developmental point of view to analyze whether FDI in the long run increases or decreases the amount of foreign exchange that a developing country has at its disposal. If it increases foreign exchange inflows, FDI would have a positive effect, as it would enhance the host country's debt service capacity and actually stabilize the prevailing currency regime. On the other hand, if it decreases foreign exchange inflows, the impact of FDI on the host country's macroeconomic constellation would be clearly negative, as FDI would aggravate an already unstable economic situation and put even more pressure on the existing currency regime. In the following we will discuss possible macroeconomic and currency risks attached to FDI for host countries.

A comprehensive assessment on this issue requires taking into account all capital inflows and outflows, as well as the change in trade revenues induced by FDI. First of all, as foreign investors expect to make a profit on their investments, investment-related financial outflows will in the long run exceed initial inflows, if the investment is successful. Outflows will be of various types, depending on the specific instrument of capital inflows—FDI, portfolio investments, or loans. Table 1 gives an overview of the flows related to foreign capital from the host country's point of view.

Box 4.2: Inflows and Outflows of Foreign Capital

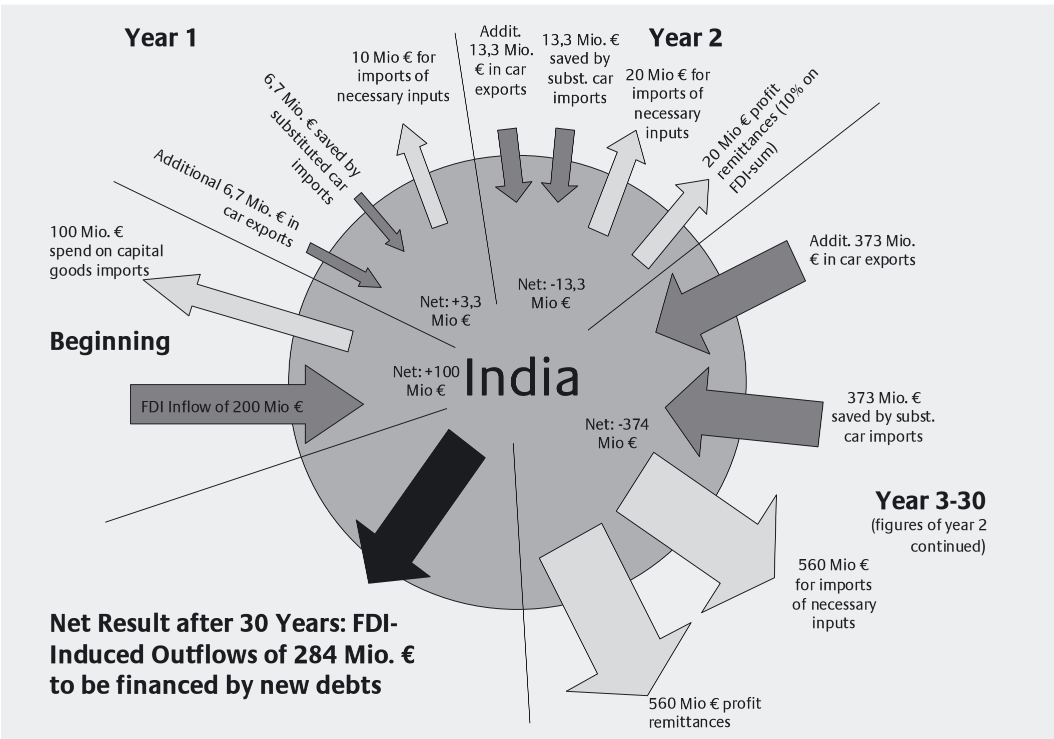
Inflows				Outflows
FDI	→		→	Profit repatriation (and final dissolution of FDI)
Portfolio Investment	→	Developing Country	→	Dividends on and final sales of shares; interest, and amortization of bonds
Loans	→		→	interest and amortization

Let us take the hypothetical example of an FDI for a better understanding of its BOP implication[6]. Volkswagen Germany invests €200 million in India to set up a subsidiary »Volkswagen India« to produce cars. From an Indian BOP perspective, that means a €200 million import of capital (registered in the capital account), and a transformation of the €200 million into domestic currency. For reasons of simplicity, let us assume a stable exchange rate of €1 Euro = 50 Indian Rupees (Rp.). Accordingly, the Bank of India can add €200 million to its foreign exchange reserves, and has to provide Volkswagen India with 10 billion Rp.

From the initial investment sum of 10 billion Rp., Volkswagen India spends 5 billion Rp. to buy real estate and construct buildings, the other 5 billion Rp. are spent to import machinery and other capital goods for the production site. As a result, 5 billion Rp. are exchanged for €100 million to pay for the imports. The net effect so far is in an inflow of €100 million, or 5 billion Rp., which amounts to an increase of foreign exchange reserves in the Bank of India's accounts, also equal to €100 million or 5 billion Rp. We will come back later to what the Bank of India might do with this money and what implications that has for the BOP. The long-term output of the production site of Volkswagen India, financed by FDI of 10 billion Rp., is estimated at 3.3 billion Rp. or 66.7 Mio € per year. The necessary share of imports for production (let us assume 30 per cent) is to remain stable, accordingly 20 Mio. € per year are to be spent for imports of semi-finished products and raw materials. Assuming that Volkswagen India exports 20 per cent of its output of cars and substitutes by another 20 percent otherwise imported cars, that means that by the 3.3 billion Rp. of total output, the balance of trade will benefit from 0.67 billion Rp. or 13.3 Mio. € in additional car exports and another 0.67 billion Rp. in reduced car imports, ending up with a strengthened trade balance of 1.33 billion Rp or 26.6 Mio. €. These figures should be applicable during the entire period of the investment. For the first year however, we assume that output will be only half this level, because the new machinery has to be introduced, workers have to be trained, etc. Therefore we also assume that Volkswagen India will earn no profits in the first year. Altogether the net current account effect of the

6 The assumed figures might sound quite arbitrarily. We will assess the relevance of changes in these assumption later in this section.

Fig 4.1: Flowchart of hypothetical FDI to India



investment (imports of inputs for production of 0.5 billion Rp. or 10 Mio. €, import substitution of cars by 0.33 billion Rp. or 6.7 Mio. € and car exports of 0.33 billion Rp. or 6.7 Mio. €) is slightly positive in year 1 (a trade surplus of 3.3 Mio.€) (for an illustration of these figures see Fig 4.1).

From the second year onwards, we expect output to reach the target of 3.3 billion Rp. and to be profitable. Annual profits of 1 billion Rp. or 20 Mio.€ (ten per cent of the initial FDI sum) are to be repatriated to Volkswagen Germany. When adding these different BOP effects of the investment (imports of inputs for production of 1 billion Rp or 20 Mio.€., import substitution of cars by 0.67 billion Rp. or 13.3 Mio. €, car exports of 0.67 billion Rp. or 13.3 Mio. €, and profit repatriation of 1 billion Rp. or 20 Mio.€), the annual net financial balance is minus 0.67 billion Rp. or minus 13.3 Mio. €, without considering the initial amount of capital inflow of 5 billion Rp.. Hence, after 7.5 years the BOP net effect of the initial investment will become negative and has to be financed by new debts, thereby increasing India's external debts by an annual amount of 0.67 billion Rp. or 13.3 Mio. € respectively. As can be seen from the chart, the overall result of the considered investment by Volkswagen in India for a time span of 30 years would induce net financial outflows of 284 Mio. €. This sum does not provide for the option that Volkswagen decides to withdraw its investement at some stage and does not include any interest payments due, if the financial outflows had to be financed by new debts.

Obviously, to have a long term positive effect on the BOP, FDI has to satisfy several conditions:

1. The rise in exports and the amount of substituted imports caused by the investment must exceed the necessary imports of inputs for production (13.3 Mio. € additional export earnings versus 6.7 Mio.€ additional net expenses for imports). Consequently, this condition is met in the above case with a current trade surplus of 6.7 Mio.€.
2. Even more, this positive net trade balance on current imports and exports (6.7 Mio. €) must be high enough to compensate for the drain of repatriated profits (20 Mio. €). If this condition is not fulfilled it would leave the country with a structural annual current account deficit of 13.3 Mio € for the duration of the investment.

Let us now take a look at whether the meager success (from a BOP perspective) might only be caused by misleading assumptions. Let's define BOP sustainability of a particular FDI-project to be the absence of a structural current account deficit. That would mean that the mix of FDI-induced foreign currency flows in terms of (1) exports, (2) substituted imports, (3) imported inputs for production, and (4) profit remittances would have to end up as a zero-sum game, or even with a net positive outcome.

(1) and (2): This could for example be achieved by increasing the assumed share of exported cars (20 per cent in the example) and/or the rate of import substitution (another 20 per cent), which combined would have to rise by 18 percent to 58 per cent. Obviously, Volkswagen's decision to set up a subsidiary in India would be significantly driven by the objective of providing the promissing Indian market with cars. Therefore it would seem somewhat unrealistic for Volkswagen to export a too-high share of output to countries other than India.

(3): Another option would be the reduction of imported inputs. To reach BOP sustainability, imported inputs would have to be reduced from the assumed 30 per cent to less than 12 per cent. Yet, to realize this reduction, the technological level of the production-site would certainly have to be upgraded to allow more parts and components to be locally produced rather than imported. This upgrade in technology would require even more imports of machinery and other capital goods.

(4): Some might also argue that the assumption of a 10 per cent rate of return on FDI is too high. In our example, a decline to 3.5 per cent would be necessary to prevent a net negative impact on the BOP by the investment. However, in a policy research report dated 1997, the World Bank estimates the average rates of return on FDI in developing countries between 1990 and 1994 to be 16-18 per cent and even higher in Sub-Sahara-Africa with 24-30 per cent (Woodward 2001: 93f.).

There are two other assumption that might be questioned. First of all, is it necessary to spend 50 per cent of the initial investment sum on imports of machinery and other capital goods? Of course, the answer is somewhat arbitrary, but as highlighted earlier in (3), the lower the initial imports of machinery (i.e. the technological capacities of the FDI-plant), the higher will be the need to import semi-processed goods, as they then simply could not be produced domestically. As the most important criterion of BOP sustainability is to have no structural current account deficit, it might be reasonable to spend a share even higher than 50 per cent of the FDI sum at the beginning, to decrease the import dependency of the whole project.

Secondly, is it not too modest to expect an annual production output of cars worth 3.3 billion Rp. or 66.6 Mio. € from a total investment of 10 billion Rp. or 200 Mio. €? Of course, car manufacturing in India would employ more labor-intensive production techniques than in Germany, the US or Japan. However, the automobile industry, even when organized by TNCs in developing countries, remains a highly capital-intensive sector. Here, we therefore assumed a capital output ratio (COR) of 3.0 (three units of capital stock are necessary to produce one unit of output). Car manufacturing in industrial countries has a higher capital output ratio.

BOP sustainability may be achievable through a combination of adjustments in several parameters, but, as explained, some adjustments are inversely interlinked (like the initial imports of capital goods and the dependency on imported inputs), and might therefore offset each other.

Finally, one should pay some attention to the oft-stressed argument by the IMF and the World Bank that FDI inflows can help to finance debt service and may even contribute to reducing the overall debt stock of developing countries[7]. In our example the Bank of India received net 5 billion Rp. in foreign currency at the beginning of the FDI. Of course, these additional reserves would not only be piled up in the basement of the Bank of India, but would be used for a number of purposes beneficial to the Indian economy. First of all, even the mere piling up of foreign reserves by the Bank of India has some benefit, as it strengthens its potential scope for currency interventions. This can in and of itself contribute to discouraging speculation against the Indian rupee, and therefore help to prevent currency crises. Furthermore, foreign reserves can actually be employed to stabilize the exchange rate of the rupee by interventions of the Bank of India. As we will see below, developing countries' currencies are often under threat of depreciation, thus the Bank of India's intervention can help to underpin the credibility of the currency and thus help reduce domestic interest rates.

Finally, and very significantly from a BOP perspective, the additional foreign reserves could be used to pay off some of India's foreign debt, and hence help to reduce future debt service payments. Whereas the first two options can hardly be addressed in our example, the latter option of debt reduction can be easily integrated into our calculations. Let us assume that India pays an interest rate of eight per cent on at least part of its external debt (concessionary debts might be cheaper), and will repay these debts first. Furthermore, to finance a current-account deficit, India would have to take on new debt at the same rate of eight per cent. In this case, the FDI-induced 5 billion Rp. will initially help to reduce Indian debts, but later on debt will rise again due to the structural current-account deficit. As one can see from the chart below, the long term effect on the debt stock is very negative. After thirteen years, the net impact of this FDI on debts reaches a break-even point. After that, it leads to an exponentially rising stock of external debt of more then 20 billion Rp. or 400 Mio. €—double the amount of the initial FDI sum, for an investment horizon of thirty years. These figures do not even provide for the contingency that the foreign investor might dissolve the investment and repatriate his capital. To additionally account for that, the country

[7] Since the late 1980s, one of the main pillars of the international debt management by the IMF and the World Bank has been to advise indebted developing countries to privatize public enterprises, sell them to foreign investors, and use the proceeds to reduce the country's debts (»debt to equity-swaps«).

would have to acquire another 10 billion Rp. in foreign exchange to finance the disinvestments, increasing the negative net balance to over 30 billion Rp or 600 Mio. € in debts.

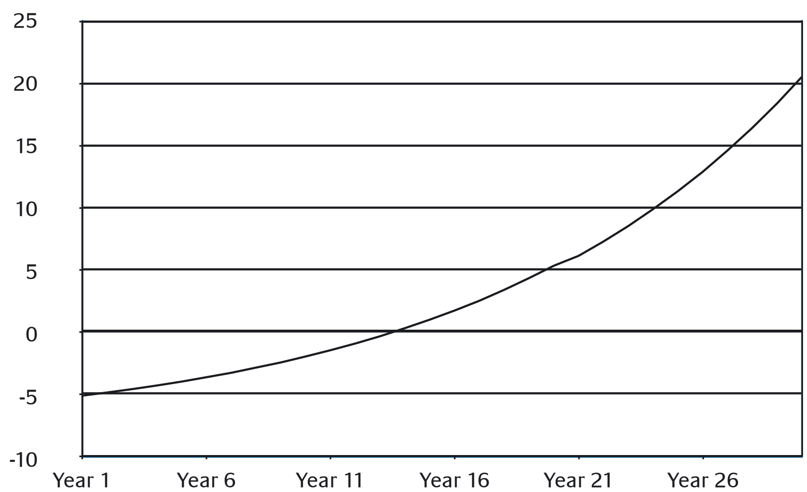
Generally speaking, the example tells us that FDI can involve serious risks for the balance of payments account of a developing country, even if the particular FDI is considered a success in terms of technology and managerial skills transfer and revenues from sales. Any FDI must at least create a net positive trade effect as high as the repatriated profits, if the foreign exchange constraint is not to be increased.

The BOP risk is the higher, the more an FDI is (1) designated to produce for the domestic market of the host country rather than for export and without significantly substituting imports; and (2) the higher the share of imported inputs for FDI-production is. While our example at least assumes a significant level of added value in the host country (only 30 per cent were imported inputs), FDI is quite often motivated only to maintain and secure production of the FDI company in its home country, by expanding its market share in the host country. Such a market expansion strategy implies that almost-finished products will be imported into the host country, only to be marginally refined. FDIs of this type can end up with shares of imported inputs of up to 90 per cent and more. In a recent study on the role of FDI and transnational corporations in the economic development of transition countries, Joze Mencinger (2003: 491) draws conclusions that can at least partially be transferred to »emerging markets« in the South as well: »Indeed, current account and FDI were strongly linked; the bigger the inflow of FDI into a country, the higher its current account deficit and foreign debt. While foreign trade increased through FDI, multinationals contributed more to imports than to exports.«

It is quite difficult to undertake reliable empirical studies on the specific BOP implications of FDI, one major reason being a severe lack of accurate and reliable data. International institutions such as the IMF and the World Bank have not taken FDI sufficiently seriously to date to compile a statistical overview. To Woodward (2001: 50), this is reminiscent of the insufficient level of data provided on the mounting external liabilities of developing countries on the eve of the debt crisis of the 1970s. »The ignorance among lenders, borrowers and regulatory bodies of the volumes of debts … was a major element in allowing the crisis to occur.« Today we have a far better picture of developing countries' debts, but »our knowledge about the scale of private sector liabilities—including … direct and equity investment—is at least as limited as knowledge of public sector debts was in the 1970s.« (Woodward 2001: 51).

Even more difficult is the data-situation on FDI-related trade. Even if there were figures on the change in export revenues induced by FDI, it is almost impossible to assess to what

Fig 4.2: Reduction or increase of foreign debt due to FDI over 30 years (in bill Rupees)



extent FDI-production substitutes for imports. We therefore have to resort to a more general distinction between various types of FDI, depending on the motives they are following. As the motives for FDI differ, so do the BOP-implications.

One motive of FDI is to get access to large domestic markets like Brazil or India. Such FDI sometimes involves real added value for the host country (as in our example of Volkswagen India), in other cases, it is only set up to sell goods already processed in other parts of the world. The worst case scenario from a BOP perspective is FDI that produces only for the domestic market, relies on imported inputs for production, has basically no import substitution effect and is very profitable. A typical example of that are subsidiaries of fast-food chains like McDonalds.

The second motive for a company to undertake an FDI consists in employing cheap labor to produce for exports. As pointed out earlier, there is a very modest record of export-oriented FDI inflows in terms of technology transfer, particularly when completely insulated from other domestic firms in export processing zones (EPZs, for details see Chapter 5). Even if they do not bring along the promised technological spillovers, they might look more favorable from a BOP perspective. However, one must not overestimate the positive BOP potential, as EPZs e.g. in the textile industry tend to have a very low level of value added and therefore, also have a very high share in imported inputs.

In its Trade and Development Report 1999 UNCTAD (1999) undertook some empirical assessments of FDIs. By distinguishing between net transfers effect (FDI inflows minus profits, royalties and license fees) and the trade effect (comparing exports from FDI and imports associated with FDI), it draws a warning conclusion.

»Examining three case studies, it finds that in Malaysia the activities of foreign firms had a negative impact on both the net transfers and the trade balance in the 1980s and early 1990s.« Similarly, in Thailand FDI had a negative net impact on the trade balance in the late 1980s and early 1990s on top of rising payments abroad for profits and royalties and these features of FDI contributed to external imbalances that played an important role in the country's subsequent crisis.

For Brazil, the secretariat of the Economic Commission for Latin America and the Caribbean of the United Nations (ECLAC) has warned that »in the near future, there will be a significant deterioration in the balance of payments of transnational corporations in the Brazilian economy« (summary of the UNCTAD findings by Khor, 2000: 37). And: »[T]he Bank for international Settlements has singled out ›significant weakening of the relationship between Foreign Direct Investment and the growth of exports in the 1990s‹, as a factor contributing to payment problems and the crises in East Asia« (UNCTAD, 1999: 123).

One reason for this might be the reductions in regulations due to capital-account liberalization. FDI has thereby been allowed to move deeper into the sector of non-tradables, particularly in services like banking and insurance (see also Chapter 5). Trade liberalization, on the other hand, has contributed to the availability of intermediaries by imports, and sometimes further reduced the share of value-added in production in the host country.

To conclude, if FDI is to have any positive impact from a balance of payments perspective, it must generate more foreign exchange inflows than outflows in the medium and long run. This can only be achieved by FDIs that raise more net export earnings than what they necessarily generate in terms of profit remittances. As this is by no means automatic, it needs political regulation to make this condition to be met (for a deeper discussion of FDI regulation see Chapter 9).

4.3 FDI, Exchange Rates and Domestic Interest Rates

Apart from the direct BOP-consequences discussed above, FDI may imply strong repercussions for the exchange rate. As this is one of the most important parameters affecting the international competitiveness of any country, it must be treated as a strategic price of the economy, and deserves particular attention. If one of the main concerns with regard to FDI is that »[t]here is a general tendency for FDI to generate a net outflow of foreign exchange.«

(Khor 2000: 40), then this net loss can only be financed by foreign exchange earnings from other exports, or by importing even more capital from abroad.

The FDI of Volkswagen in our above example generated foreign debts for India of about 20 billion Rp. in a time span of 30 years, and every additional year will add to this figure, as long as the structural current account deficit prevails. Furthermore, these debts will cause themselves an even higher outflow of foreign exchange in the future as not only the originally loaned sum has to be paid back, but additional interest payments occur.

Generally speaking, whenever a country imports capital, it accumulates foreign debts or other future liabilities to the outside world (such as streams of future profit remittances to foreign investors). If the imported capital does not generate sufficient foreign exchange to service and repay the debt or to pay the profit remittances due, the country will inescapably be at risk of a balance of payments crisis with all the well-known negative consequences, as demonstrated during the Asian crises, such as extreme currency devaluations, real appreciation of foreign-denominated debt, bankruptcies of companies and banks and in the worst case, the default of the entire economy.

Whenever a country is accumulating debts and other future liabilities, economic actors (such as investors, speculators, domestic wealth owners etc.) can easily anticipate that its exchange rate will at some point devalue. This is unavoidable, for if long-term financial outflows exceed inflows, i.e., if demand for foreign exchange exceeds demand for domestic currency, this will certainly put pressure on the value of the domestic currency and thereby depreciate the exchange rate. National central banks can intervene in the foreign exchange market to stabilize the current level of exchange rate in the short term. However, in the long term, central banks do not have sufficient reserves to finance structural foreign exchange deficits of the economy, and the country will end up in a BOP crisis.

A balance-of-payments crisis affects not only foreign creditors, domestic companies and banks or the state, but also capital owners in developing countries. Any devaluation of the local currency—be it in the course of such a balance-of-payments crisis or in the course of so-called crisis management by the IMF—depreciates wealth denominated in domestic currency. Therefore, owners of assets in the South do not hold their wealth only in form of such physical assets as real estate, there is a significant incentive for them to hold their nominal financial assets in foreign currencies that are considered less vulnerable to currency risks (i.e., dollar accounts in their home countries or dollar or euro accounts in banks in the United States, Europe, Japan or such offshore financial centers as the Cayman Islands, the Bahamas, the Virgin Islands, etc.). However, what looks very rational from the individual point of view of domestic wealth owners causes a tremendous problem to developing economies as a whole: dollarization and capital flight on a large scale.

Given an international environment of liberalized financial markets with high mobility of capital, wealth owners can hardly be prevented from shifting their financial assets to whatever currency they like. Apart from capital controls, the only way to keep such financial assets denominated in the currency of origin is to offer more favorable domestic conditions, i.e. to have domestic interest rates that are higher than those at the international level, as a premium for the risk of domestic currency depreciation. The result is simple and far-reaching: developing countries tend to have higher real interest rates than industrial countries, and thereby repress their national scope for investment and economic activity as a whole. According to one school of economic thought, this inescapability of higher domestic interest rates in countries that attract high net capital inflows forms one of the main underlying explanation for the ongoing and widening gap between developing and industrial countries (for an in-depth analysis of this mechanism, see Schelkle, 1995 and Metzger, 2001).

If the above analysis is correct (and the historic experience with the decay of developing countries' exchange rates lends this argument considerable weight), the developmental risks of a growth-cum-debt strategy in which net capital imports are supposed to fuel growth at the cost of an increasing accumulation of foreign-currency-denominated debt counteracts a viable and sustainable economic catch-up process. Hence, whether FDI has positive or negative effects on the domestic economy from a developmental point of view decisively depends on whether it eases the burdens of foreign exchange constraints on developing countries.

4.4 FDI—The New Magic Bullet for Development!?

Due to the negative experiences with loans and portfolio investment in the recent debt and financial crises of developing countries, there has been a considerable appreciation of the role of FDI in recent official development thinking of institutions such as the International Monetary Fund (IMF), the World Bank, the Organization for Economic Cooperation and Development (OECD) and the United Conference on Trade and Development (UNCTAD). Whereas portfolio investment and short-term loans are increasingly considered as too volatile and harmful to financial stability in developing countries, FDI is promoted as a successful and nearly risk-free means of earning foreign exchange and getting access to new technology. Moreover, as aid budgets of the major public donors stagnate or even shrink, developing countries are advised to rely more on private sources to finance development—a view which lies at the heart of the Monterrey Consensus on development financing.

FDI is increasingly seen by many scholars and international institutions as the best way to modernize domestic infrastructure; it is

Box 4.2: The Expected Gains from FDI

Immediate effect from FDI	Spillover mechanism	Positive Effect to the host country
Micro-level: - Transfer of new technology and related skills to firms with direct FDI involvement - Introduction of new processes, including managerial skills and know-how	Micro-level: - Qualification and training of local staff of subcontractors - Additional and sufficiently paid jobs - Productivity gains as skilled workers move to local firms - Integration of local firms and mergers in new lines of production	- Positive effect on social development through income gains and reduction of unemployment rates - The overall effect of raising state income from corporate and income taxes - General stimulation of the domestic economy - More and better services; from financial services to healthcare and social security - Modernization and extension of physical and social infrastructure - Relaxing problems with debt service - Less risk of financial crises
Macro-level and Balance of Payments (BOP): Foreign capital inflows to the country	Macro-level and Balance of Payments (BOP): - FDI helps generating foreign exchange by increasing export revenues or decreasing import demand - Integration into the world market thereby increasing national competitiveness - FDI inflows are more stable than other inflows	

assumed that FDI advances export production, helps generate foreign exchange, and thereby eases the pressure on the balance of payments (for the balance-of-payment implications of FDI, see Chapter 4.2); and it is hoped that FDI will contribute to the technological upgrading of the economy and facilitate a successful integration into the world economy. FDI is supposed to generate new jobs and—through the introduction of new production processes—contribute to the qualification and training of workers. Moreover, some assume that FDI stimulates the domestic economy and raises state revenues through additional corporate and income taxes[8]. In a word, FDI seems to be a panacea for developing countries to overcome their economic, structural and social rigidities.

However, there are also growing numbers of voices that warn against overestimating the potential role of FDI, particularly if attracted by costly public sweeteners. This view is specially emphasized by Alfaro, Chanda, Kalemli-Özan and Sayek (2003) in a working paper on FDI spillovers prepared for the IMF's African Department. The authors conclude that, because there is no reliable evidence for positive effects to a country's economic development, »countries should weight the costs of investment incentives targeted at attracting multinational enterprises versus the costs of improving local conditions« (Alfaro, Chanda, Kalemli-Özan and Sayek 2003, p. 15). According to the findings of IMF and World Bank critic Yash Tandon, the domestic approach is more promising in any case—even in terms of attracting investment. He states that according to historical evidence »it was growth that attracted FDIs, and not FDIs that brought growth« (Tandon 2000 p. 3)[9]. The central assumption of the WDR 05 that (foreign) investment leads to higher growth rates, thereby reducing poverty can thus be questioned since »there is not a robust, causal link running from FDI to economic growth« (Carkovic and Levine 2002, p. 3).

The widely held view that FDI engagements of multinationals are per se of a relatively long-term nature and therefore sustainable has also been challenged by various authors. Since transnational corporations have an interest in liberalized financial markets which allow easy transfers and conversion of investment capital, efforts to attract FDI often go hand-in-hand with the liberalization of financial markets in general and capital-account liberalization in particular. Empirically, it is impossible to clearly distinguish between FDI on the one hand and portfolio investment on the other; hence, FDI may well contribute to instability since »profits from investment are as mobile as portfolio flows and can be reinvested outside the country at short notice. (Profits may surpass the initial investment value and FDI may thus contribute to capital export).« (Mwilima, 2003, p. 14). According to a South Centre study mentioned above (1999), FDI became increasingly volatile during the 1990s, as investors were put in a position to more easily liquidate and transfer their once invested capital through liberalization of markets.[10] Moreover, David Woodward pointed out that the scale FDI has reached today already has anything but a stabilizing effect on the financial systems of developing countries. He gives convincing evidence for parallels to the 1980s debt crisis, arguing that FDI inflows, like loans, »contribute to current-account deficits, and thus to dependence on foreign capital and vulnerability to crises.« (Woodward, 2003, p.9)[11]

The available studies concerning spillovers from foreign-owned firms to domestic enterprises, supposedly triggering the above mentioned chain of economic growth, are to some extent controversial in their findings. But they give evidence to doubt the existence of any general positive spillover mechanism regarding the support of development. The findings of

8 Among others, an OECD report concluded: »... FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development. All of these contribute to higher economic growth, which is the most potent tool for alleviating poverty in developing countries.« (OECD, 2002, p. 5).

9 A view that is supported by the findings of other authors as well. Alice H. Amsden for example concludes at the end of a chapter on technology transfer: »Foreign investors — first individuals and then firms — typically arrived on the scene after an industry had already been started.« (Amsden, 2001; p. 69).

10 »...with the introduction of financial liberalization and foreign exchange markets, those involved in FDI are able to liquidate their investments rapidly by borrowing funds on the local market, buying foreign exchange and taking capital out of the country as they choose.« (The South Centre, 1999, p. 4).

Aitken and Harrison (1999) in their study on beneficial effects from FDI to domestic firms in Venezuela prove that technology transfer and productivity gains of foreign owned firms cause a loss in productivity and market shares of domestic firms.

Other studies have shown that transnational corporations did not tend to employ significant numbers of local employees and if they did, the jobs require no high level of skills. The mobility and diffusion of qualified personnel to local firms was low, which is one of the reasons why technology transfer to domestic enterprises did not occur at a sufficient level. As foreign owned firms are predominantly subsidiaries of multinationals, they hardly shift research and development activities to the host country. This fact also added to the shortage of technology, knowledge and skills transfer. Last but not least, the limited subcontracting to local suppliers (see for example the case study of Bangladesh in this report) hampered the integration of local firms in new lines of production and their connection to new markets[12].

It can thus be concluded that FDI does not in and of itself automatically generate positive spillover. Whether or not such spillovers in fact occur is heavily dependent on (a) local conditions (for example sufficiently developed financial markets[13] or the country's already existing highly educated workforce;[14]) and (b) the ability of the host country to regulate and tailor FDI inflows.[15]

4.5 FDI in History—Failure and Success

Failure or success of FDI is closely related to regulations applied for FDI inflows as well as to the level of economic development in the respective countries. Attempts to impose regulations on FDI that would enhance the chances for positive effects on the host country's economy—for example by assuring that a minimum of spillover and technology transfer actually takes place—are widely seen as »wrong signals to investors,« and therefore harmful to the goal of »improving the investment climate for growth and poverty reduction.« Regulations as such are suspected of shying away beneficial FDI. The less you have, the more attractive your country is for foreign investors.

1. Failure

The case of Mexico[16] is well suited as an example of the failures of an FDI-centered development strategy. Among the reasons is the fact that it is far from being among the least developed countries, where the reasons for a shortage of FDI oriented development efforts are often said to be found in insufficient preconditions within the host country's institutions, or its general retarded level of human and economic development.

Mexico undertook a development strategy based on import-substituting industrialization (ISI), aimed at building up its own industry independent of foreign investors and even foreign markets. The measures taken during the period between World War II and the early 1980s included several forms of protectionism as well as government subsidies linked to local-content requirements, price control and the build up of usually state owned »national firm leaders« (Amsden, 2001) in key industrial sectors.

In reaction to the downturn of the Mexican economy during the 1982 debt crisis, Mexico's government initiated several measures known as »Apertura—›opening‹ Mexico to foreign trade and investment.« (Gallagher, Zarsky, 2004 p. 8). A period of progressive liberalization and deregulation had begun. It was marked by Mexico's signing of the General Agreement on Tariffs and Trade (GATT) in 1986, several investment-related treaties negotiated within the WTO during the 1990s, and its active role in the implementation of the North American Free Trade Agreement (NAFTA—1994). State owned firms were privatized, subsidies suspended, price controls eliminated, government-friendly unions favored in negotiations and so on. »These trade and investment

11 See also »The Next Crisis? Direct and Equity Investment in Developing Countries« (Woodward, 2001).

12 See e.g. Aitken and Harrison (1999) and, less recent, Germidis (1977).

13 Alfaro, Chanda, Kalemli-Özan and Sayek (2003).

14 Borensztein, De Gregorio and Lee (1998).

15 See e.g. Caves (1999) on thoughts about possible »efficiency of conditional deals.«

16 Unless otherwise indicated, the information in this example is taken from a recent paper by Kevin P. Gallagher and Lyuba Zarsky published by the Global Development and Environment Institute in February 2004. (Gallagher, Zarsky, 2004).

policies set the stage for FDI in the manufacturing sector to be the engine of Mexican development.« (Gallagher, Zarsky, 2004 p.11).

There is no doubt that Mexico succeeded in attracting FDI and they brought productivity gains as well as an increase in manufactured exports. However, hardly any of the hoped-for beneficial effects concerning industrial development came true: According to Gallagher and Zarsky's evaluation, new jobs where almost exclusively created in Export Processing Zones (known as maquiladoras in Mexico), which hosted most of the new export-oriented industries. These jobs were few in number[17] and due to a policy favoring FDI, local enterprises suffered from low investment[18] and therefore failed to hire more employees. Besides, Gallagher and Zarsky point out, »jobs in the foreign sector are vulnerable to competition from Asia and to changes in the global markets …[the] minimum wage in Mexico has declined by more than 70 percent since 1982« (Gallagher, Zarsky, 2004 p. 45).

Spillovers in the form of transfer of technical innovations, skills and knowledge to domestically owned firms are scarcely found. Better access to global markets is also limited to enterprises with direct FDI involvement. Gallagher and Zarsky conclude that the FDI-led integration strategy to promote industrial development has resulted in higher FDI-related capital inflows and a growth of the export oriented sector. This FDI driven export sector shows a high import intensity and therefore operates to a great extent without involvement of the domestic economy.

Apart from an increase in export revenues, which has been more than offset by a strong rise in imports, no positive effects for the domestic economy and the population as direct results of FDI inflows in Mexico are in evidence.

2. Success

Obviously there is no causal link between opening a country for FDI and economic benefits and development. But how then did the industrialized countries, which are promoting these incentives as prerequisites for successful economic development, deal themselves with FDI in the past? Did industrialized countries open up their economies to the world market from the very beginning of their own development process? And what role did active economic policy play in their catch-up process?

A convincing answer is given by Ha-Joon Chang and Duncan Green (Chang, Green 2003): Based on an extensive study on the history of industrial development[19] they emphasize, that industrial countries used a broad variety of restrictions, bans, regulations, informal mechanisms and performance requirements to regulate FDI inflows and make them work for their local economy's transformation and development. Some of them have used these regulations to this day;[20] almost all the others had strongly regulated FDI inflows at least during their period of industrializing catch-up. Chang and Green point out that »non-discrimination [of FDI] is better seen as an outcome of development, than as] a cause«[21]. Now that these countries have achieved a mature industrial structure and evolved transnational corporations with a strong market base in their home markets, their TNCs can easily compete with comparatively small companies and firms in developing countries. Hence, market openness and deregulation as is repeatedly called for by industrialized countries' politicians and officials serves to expand first and foremost

17 Between 1994 and 2002, the manufacturing sector added 637,000 new jobs, some 96 percent of them in maquiladoras. On the other hand, some 6.5 million additional people were seeking jobs, who were thought to be unemployed due to the effects of the FDI-led export-oriented development strategy (Gallagher, Zarsky, 2004 p. 44-45).

18 There are various reasons for the severe drop in domestic investment, which fell by half between 1994 and 2002, while the FDI share of investment more than doubled, from 5.4 percent in 1981 to 12.6 percent in 1993 (both as a percentage of GDP). These include the »anti-inflationary macroeconomic policy package,« which led to high national interest rates and placed those at a disadvantage who were unable to acquire financial resources on the international financial markets. These interest rates also attracted foreign capital inflows (portfolio) and led to a rise in the peso, reducing prices for imports and raising prices for Mexican products. Export-oriented production that relied on imports profited, while producers oriented toward the domestic market faced cheap imports (Gallagher, Zarsky, 2004 pp. 26-27).

19 Published by Chang in his influential book »Kicking Away the Ladder« 2002.

20 One example are state owned enterprises in industrial key sectors. Governments tend to keep some control even after privatization by holding a considerable part of shares. See Chang, 2003 for additional examples.

market opportunities of TNCs. In preaching extensive deregulation as the way to success, industrialized countries' governments ignore or even persistently deny their countries' own strategies and policy approaches towards FDI in crucial phases of their own past economic development.

To give an idea about the wide range as well as the scale of protectionism and foreign investment discrimination in favor of national industry promotion and infant industry protection, Chang quotes from a book by historian Mira Wilkens on the industrial development of the United States[22]. Towards the end of the 19th century, the US economy was on its way to catching up with the then internationally leading British economy-, which had risen to its strength by means of active industrial promotion and gains from free trade with countries belonging to the British colonial empire. Furthermore, the UK dominated the world monetary system by having established the British Pound as world money in all international transactions, and the Bank of England was in a position to influence world financial flows by variations in its interest-rate policy.

The period in question is roughly an extended 19th century, up to the beginning of World War I. Chang concludes that the USA used a number of regulations to attract foreigners' investments while avoiding foreign control of its economy.[23] The first step toward more economic and political sovereignty was the birth of the US central bank: »In the financial sector, legislative provisions were made in the charter for the country's first quasi-central bank, the first Bank of the USA (…) in 1791 to avoid foreign domination. Only resident shareholders could vote, and only American citizens could become a director. And thanks to these provisions, the Bank could not be controlled by foreigners, who owned 62% of the shares by 1803 and 70% by 1811.« (Chang 2003, p. 2)

Apart from the financial sector domination, heavy influence by foreign investors was also prevented in several other crucial areas: Foreign investment in land was controlled—sometimes even banned—through the federal Alien Property Act (1887) and twelve state laws enacted between 1885 and 1895.[24] Likewise, the mining sector was privileged to US citizens and companies incorporated in the USA through several federal mining laws passed in 1866, 1870 and 1872.[25]

A clear and straightforward measure was taken to ensure spillovers in skills and to compel foreign subsidiaries to perform sufficient workers training. »Interesting in relation to FDI in manufacturing was the 1885 contract labor law, which prohibited the import of foreign workers. This applied also to national companies, but it obviously affected foreign firms more, especially in relation to the import of skilled workers (Wilkins, 1989, pp. 582-3). Many TNCs did not like the law because it restricted their ability to bring in skilled workers from their headquarters« (Chang 2003, pp. 3-4). More over Chang found, that a number of state laws served to tax foreign companies more heavily than American ones.[26]

In the case of the US approach to catching up with other leading industrializing countries, it can clearly be stated that FDI worked for its economic development—regarding financial institutions as well as industrial development. Of course there are many more incentives necessary to realize a successful development strategy (to try to deal with all of them is of course beyond the scope of this paper). But the examples given show that tight regulations on FDI did not hamper the rise of the US to an economic power. Furthermore, the historic example of the US gives sufficient evidence that regulations on FDI were an important condition, not to say a requirement, to ensuring positive effects of FDI on development.

[21] Chang and Green 2003 p. xv (emphasis in the original).
[22] Wilkins, 1989.
[23] Chang, 2003, p. 4.
[24] Wilkins, 1989, p. 235.
[25] Chang 2003, p. 3.
[26] Chang 2003. p. 4.

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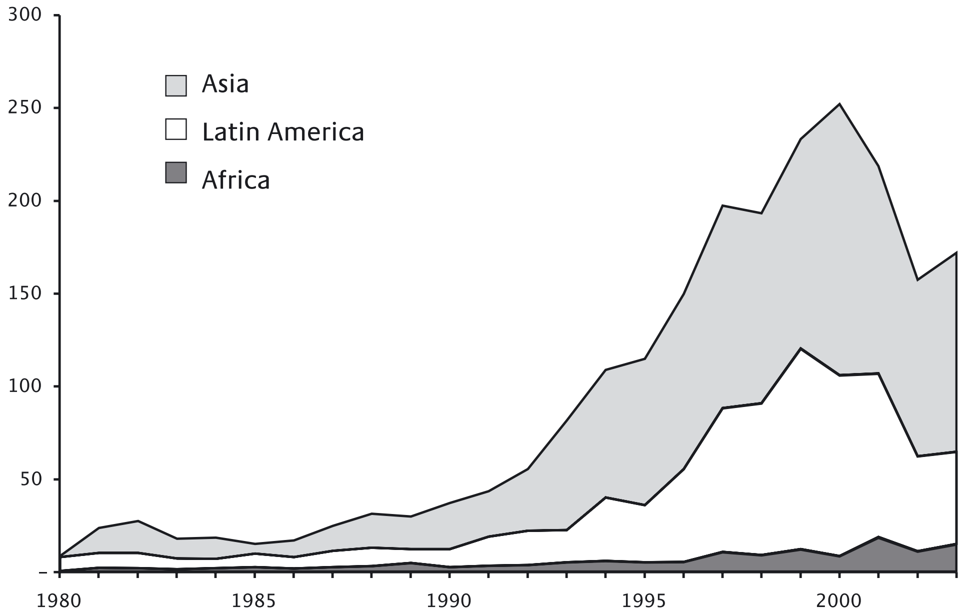
5. FDI in Strategic Industries and the Question of Sovereignty

Lydia Krüger

Since the early 1990s, the flows of FDI to developing economies have increased tremendously, reaching a record of US$ 246 billion in 2000. As Figure 5.1 demonstrates, the majority of these flows went to emerging markets in Latin America and Asia—China alone received FDI inflows of more than $400 billion during the past ten years (1993-2002).

Fig 5.1: FDI Flows to Developing Economies

Source: UNCTAD (2004): World Investment Report.



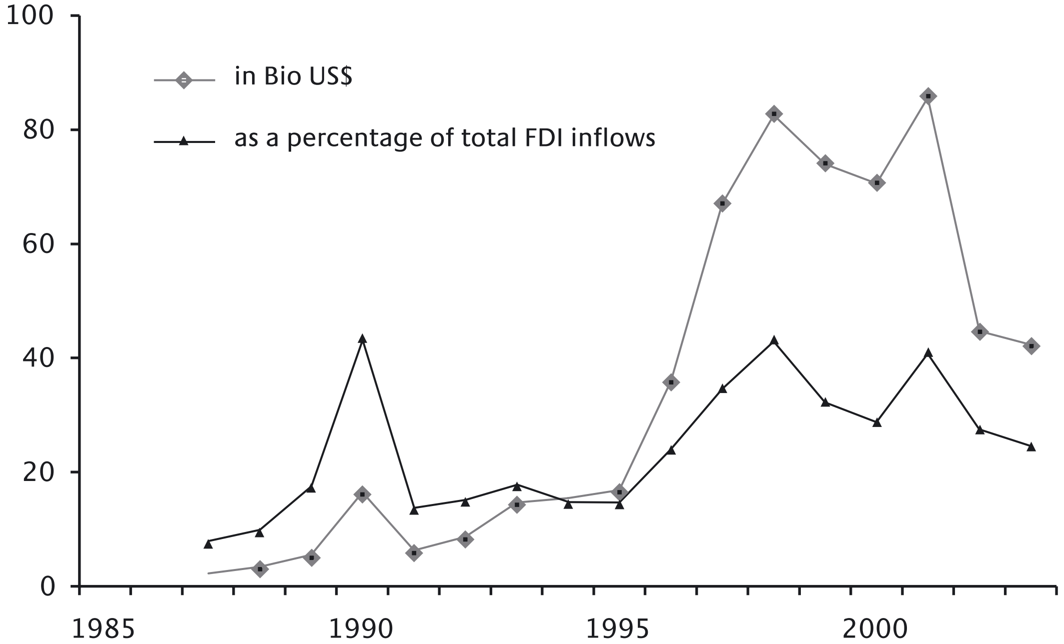
The increased sale of developing-country enterprises is closely related to the process of privatization which swept the globe in the 1990s. Though nearly two-thirds of the privatization activity in terms of revenues (which are estimated at $1.1 trillion between 1985 and 1999) took place in high income countries, the bulk of privatization transactions (in total more than 8000 between 1985 and 1999) occurred in developing countries (Brune/Garrett/Kogut 2004: 195f.).

Contrary to the 1970s and 1980s, when nearly all FDI flows to developing countries came in the form of greenfield investment, the 1990s saw a rising share of FDI related to cross-border mergers and acquisitions in developing countries. Since 1987, foreign investors spent more than $500 billion to buy assets in the developing world; Latin America alone sold corporations worth more than $318 billion.

The majority of privatizations occurred in strategic industries such as telecommunication, electricity, oil/gas and banking (World Bank 2001: 189). Because these industries are central to any modern economy, and because access to basic services such as water, energy,

Fig 5.2: Cross-border M&A sales of Developing Economies

Source: UNCTAD (2004): World Investment Report.



telecommunications, mass transport etc. is essential for the daily life of families, developing countries have for a long time tried to keep strategic industries under government control and provide public services to all people—regardless of their income or geographical location (SAPRIN 2004: 112ff.) This changed in the early 1990s, with the consolidation of neo-liberalism as the dominant approach to national development (Portes 1997: 238). From now on, the often quite poor quality of public services was used as an argument for privatization, and it was hoped that foreign investors would help to upgrade and improve the basic infrastructure in poor countries.

According to the mainstream neo-liberal ideology which is massively supported and put into practice by institutions such as the World Bank, the IMF and WTO, the privatization of public utilities contributes to growth and welfare of developing countries by improving the quality of services and the overall efficiency of the economy. More importantly, the privatization of public utilities may help reduce the debt burden of developing countries—by raising revenues from the sale of assets and by reducing government subsidies to finance public services.

Starting with Brady-Plan of the late 1980s, the privatization and sale of enterprises by developing countries (in the form of debt-equity-swaps) was promoted as a solution to the debt crisis and privatization became a standard condition of IMF and World Bank lending—which means that indebted countries in Latin America and Africa were now forced by the IMF, the World Bank and their private creditors to sell their state-owned enterprises in order to get debt relief and/or further credit. The IMF estimates that for every dollar a developing country owed the IMF in the early 1980s, it subsequently privatized state-owned assets worth about 50 cent (Brune/Garrett/Kogut 2004: 195).

But have these privatizations really been in the interest of poor people in developing countries? If we look at the experiences of countries such as Argentina or Russia, there is more evidence to the contrary: In these (and many other) cases, the privatization and subsequent sale of public utilities was connected to enormous corruption—with some foreign investors and a small domestic elite being able to acquire enormous wealth to the detriment of society as a whole. Toussaint estimates that due to corruption, the Argentinian government lost about 60 bio. US$ in the privatizations of

Table 5.1: Privatization by Region and Per Capita Income, 1985-1999

By region:	Revenues (billions*)	Transactions	Average Revenues per Transaction (millions*)
East Asia and the Pacific	318,0	831	382,7
Eastern Europe and Central Asia	23,3	2453	9,5
Latin America and the Caribbean	197,3	1601	123,2
Middle East and North Africa	19,9	419	47,5
North America and Western Europe	522,2	871	599,5
Southeast Asia	11,4	335	34,1
Sub-Saharan Africa	9,5	1662	5,7
By per capita income			
Low income	62,0	2782	22,3
Middle Income	265,9	4269	62,3
High Income	773,7	1121	690,2
Total	**1101,6**	**8172**	**134,8**

*1985 US$
Source: Brune/Garret/Kogut (2004): 197.

the early 1990s (Toussaint 2001). Moreover, it has been estimated that 200000 jobs were lost in Argentina in the early 1990s due to the privatization of public enterprises (Edwards 1995: 199).

Even more importantly, the privatization and sale of public utilities often went hand in hand with an exclusion of poor people from basic goods and services. If developing country governments fail to lay down appropriate regulatory rules for service delivery, it is likely that services become more expensive, service quality declines and/or the access of services for poor people or remote areas is restricted—as foreign investors are usually not interested in maintaining a costly infrastructure for the poorer segments of society.

Finally, it should be mentioned that the privatization and sale of profitable businesses reduces government revenue, thereby contributing to increasing indebtedness and balance of payments crises in developing countries. This problem is especially severe with regards to resource-extractive industries—sometimes even leading to violent conflicts about the distribution of rents and profits. In the following chapters I will concentrate on two economic sectors where FDI has proven to be extremely problematic as it severely restrains the sovereignty of developing country governments: The first is the oil and energy industry, the second, financial services.

5.1 Conflicts Concerning FDI in the Oil Industry

Since the early 20th century and even more since the OPEC countries decided to reduce their oil exports, thereby initiating the first oil shock in 1973, the question of who controls the worldwide network of oil production and distribution has become a central issue in international politics. With the First Gulf War and the proclamation of the so-called New World Order in the early 1990s, it seemed that the ideal of national sovereignty of developing countries—which includes sovereignty over national resources—was replaced by the right of transnational corporations to invest everywhere.

The comeback of war as a means to secure strategic resources continued in 2003 with the military aggression of the U.S. and its allies against Iraq—an aggression which not only led to outbursts of violence against U.S. troops in Iraq and other countries, but also gave rise to a powerful global peace movement, trying to fight the increasing militarization of politics. According to a UN report on »The Relationship between Disarmament and Development in the Current International Context,« global military spending rose from about $780 billion in 1999 to $900 billion in 2003 and is likely to reach $950 billion by the end of 2004—which is nearly 20 times the amount rich countries spend on development aid each year. US military spending alone has risen from $296 billion in 1997 to $336 billion in 2002 and $379 billion in 2003—which means that the U.S. government is spending nearly as much as the rest of the world combined (Deen, Thalif 2004). But whereas the United Nations openly criticized the fact that »despite decades of discussions and proposals on how to release resources from military expenditure for development purposes, the international community has not been able to agree on limiting military expenditure or establishing a ratio of military spending to national development expenditure,« institutions such as the World Bank or IMF usually avoid to criticize their main shareholders. Instead, the World Bank group indirectly assists the rich countries' grab for oil and other resources by »exploring various avenues for supporting the flow of foreign direct investment (FDI) into Iraq« (World Bank 2004: 13).

The biggest foreign investors in oil-producing countries are usually oil companies such as Exxonmobil, BP, Total Fina/Elf, Royal Dutch/Shell or Chevron/Texaco corp.—which dominate the league of global players in terms of foreign sales as the following table demonstrates:

Ranked by foreign assets, there were five oil corporations among the twenty biggest corporations in the world in 2001: British Petroleum (rank 3), Exxonmobil (6), Royal Dutch/Shell (9), Total Fina/Elf (10) and Chevron/Texaco Corp. (16). In 2003, Exxonmobil was the most profitable corporation in the world, earning revenues of $246.7 billion and a record net income of $21.5 billion (Financial Times, Jan 30th 2004).

Since all these powerful oil corporations are dependent on government support for their risky operations in developing countries, there often exists a very close relationship between state officials on the one hand and representatives from private oil corporations on the other. The most obvious example is the administration of George W. Bush—with the president and his father being former chief executives of Texas oil companies, National Security Advisor Codolezza Rize the former director of Chevron Texaco, and Vice President Dick Cheney the former CEO of Halliburton, the largest oil-service company in the U.S. But in Great Britain, too »at least a dozen BP executives held government posts or sat on official advisory committees« (Paul 2004: 14). According to Lord Brown, the CEO of BP and a close friend of Tony Blair's, »it is quite ethical and appropriate for a global company, based in the UK, to be supported by the British government« (Guardian, April 6th 2003).

There are many case studies which demonstrate that oil corporations do not shrink from »backing dictatorial governments, using bribery and corruption, promoting civil violence and even resorting to war, to meet their commercial goals and best their competitors« (Paul 2004: 12). It has therefore become more urgent than ever to effectively supervise and regulate the foreign activities of transnational corporations in general and oil corporations in particular. Instead of supporting business interests of oil corporations and promoting FDI in this industry as a means of development, it would be much wiser to increase investments in alternative (renewable) energy resources. Given the limited oil reserves on the one hand

Table 5.2: The world's top 10 non-financial TNCs, ranked by foreign sales, 2001

Corporation	Sales		Assets	
	Foreign	Total	Foreign	Total
Exxonmobil	145,814	209,417	89,426	143,174
BP	141,225	175,389	111,207	141,158
TotalFinaElf	74,647	94,418	70,030	78,500
Royal Dutch/ Shell Group	72,952	135,211	73,492	111,543
Toyota Motor Corp.	59,880	108,808	68,400	144,793
Chevron Texaco Corp.	57,673	104,409	44,943	77,572
Volkswagen Group	57,426	79,376	47,480	92,520
Ford Motor Company	52,983	162,412	81,169	276,543
IBM	50,651	85,866	32,800	88,313

Source: UNCTAD 2003: 187f.

and rapidly rising energy consumption by developing countries such as China on the other, it has become a necessity for all countries (and especially for those who consume the most) to reduce their dependence on this strategic resource—even if this implies a radical change of related production and consumption patterns. If developed countries don't succeed in reducing their dependence on oil, further resource wars and geopolitical clashes are more likely to come—another reason, why FDI in the oil sector must be closely monitored and controlled by a global regulatory system in the future.

5.2 Development Impacts of FDI in the Financial Sector

According to a joint study by the IMF, the World Bank and the Brookings Institution, the attitude of developing countries toward foreign banks and other financial firms has experienced a sea change since the early 1990s (Litan et al. 2001: 3). As Table 5.3 demonstrates, foreign banks today control more than 50 percent of the banking system's assets in several Latin American as well as Central and Eastern European countries:

What are the developmental implications of foreign ownership in financial services? Should developing countries sell their banks to foreign investors and open up their markets for foreign insurance providers—as the USA as well as the EU demand in the current WTO negotiations on financial and other services?

For institutions such as the World Bank, the answer to these questions is clear: Developing countries should open up their financial markets because »growth and stability in national economies are best served by ensuring access to the most efficient and reputable financial services providers« (World Bank 2001: x). Despite mounting empirical evidence that financial sector liberalization has contributed to severe financial crises in the countries of the South, the IMF and World Bank still argue that foreign banks increase financial stability in host countries as they possess more advanced systems of risk evaluation and usually hold a more diversified credit portfolio than domestic banks. In addition, it is argued that foreign financial service providers increase the efficiency of financial markets and improve the process of credit allocation, bringing better

Table 5.3: Participation of foreign banks in banking systems*

Region/Country	Foreign banks				Single largest foreign country
	Total	EU	USA	Other	
Latin America					
Argentina	48.4	33.6	12.1	2.7	Spain (17.9%)
Brazil	27.0	15.7	5.3	6.1	Spain (5.3%)
Chile	41.6	32.4	5.5	3.8	Spain (30.6%)
Peru	46.0	34.8	5.6	5.6	Spain (17.1%)
Mexico	82.3	53.7	23.7	4.8	Spain (41.5%)
Bolivia	25.3	10.4	4.5	10.4	Spain (10.4%)
Eastern Europe					
Poland	71.5	60.2	10.4	0.9	Italy (16.6%)
Czech Repub-lic**	70.0	58.1	6.3	5.6	Austria (40.5%)
... Rumania**	54.9	46.0	4.5	4.4	Austria (21.7%)
Bulgaria	72.0	62.9	1.3	7.8	Italy (27%)
Slovenia	66.2	66.2	-	-	Belgium (44.5%)
Slovakia**	60.5	51.8	2.8	5.9	Luxembourg (34.9%)

*Participation in terms of assets in each country's banking industry. Participation is considered to be 100 percent when a foreign bank controls a bank but owns less than 100 percent of the capital.
**Participation in terms of capital.
Source: Cárdenas/Graf/O'Dogherty (2004): 5.

and cheaper products and services for consumers as well as new technology and know-how. Moreover it is said that contrary to domestic banks, foreign banks do not get involved in »connected lending« because they are more immune to political pressure. Last but not least, it is expected that foreign banks increase the access of developing countries to resources from abroad—thereby fostering capital inflows and contributing to overall growth and welfare (see for example World Bank (2001): Finance for Growth; IMF (2000): International Capital Markets).

While there is a broad consensus within the IFIs that foreign financial institutions provide net benefits to the countries in which they invest (Litan et al. 2001: 2), there are also many critics (for example Stiglitz 2002, Vander Stichele 2004) who argue and demonstrate that

- foreign financial institutions concentrate their activities on rich clients in the centers (cherry picking), whereas financial services for small and medium sized enterprises as well as poor individuals become more expensive or even unavailable;
- destabilize the local banking system, thereby contributing to banking crises;
- undermine the local currency by preferring dollars or euros for transactions with customers;
- contribute to capital flight—especially in times of crisis;
- undermine the establishment of social security systems by offering private products for the wealthy elite.

The most important argument against FDI in the financial sector is that foreign financial institutions are mainly interessted to get access to the savings and the wealth of the rich elite whereas they are not interested in lending to small or medium-sized enterprises, not to mention poor individuals. This kind of »cherry picking« by foreign banks and insurance companies has serious consequences for the local economy: Whereas the big and profitable corporations get access to cheaper credit, the rest of the economy (and the state) has to pay higher interest rates. In many cases, small and medium-sized companies which provide the greatest number of jobs in developing countries, do not get any credit from foreign financial institutions: In Indonesia, for example, foreign banks provided only 0.005% of their total credit to small and mediumsized enterprises in 2002 (vander Stichele 2004: 65). Moreover, since big insurance companies and pension funds have a great interest in selling private insurance products or pension schemes to the richer clients in developing countries and emerging markets, it becomes ever more difficult (and expensive) for governments to provide basic services or adequate pensions for the poor.

Another important argument has to do with the impact of increased competition on domestic financial institutions. As Stiglitz has argued, most domestic financial institutions in less-developed countries have no chance to compete with international giants such as Citigroup (Stiglitz 2002: 46). This means that foreign bank entry may lead to a wave of bankruptcies of domestic banks, with serious consequences for the rest of the economy. The argument that foreign banks do not get involved in »connected lending« because they are more immune to the political pressure exerted by developing country governments can also be turned on its head: If we look at the experience of countries such as South Korea, there is a lot of evidence supporting the thesis that a government policy of directed lending at low real interest rates to strategic industries has been key to the successful industrialization of the country. Instead of following the advice given by the IMF and World Bank, developing countries should rather follow the experience of those newly industrialized countries in East Asia which protected their domestic industries from foreign competition, gave financial support to domestic companies and pursued an active and strategic industrial policy aimed at the technological upgrading of their economies.

In conclusion, we can see that since the second half of the 1980s, privatization has become a standard condition for IMF and World Bank lending—with the result that more and more transnational corporations were able to acquire formerly state-owned enterprises in a wide range of service industries (such as banking, energy, telecommunications, water etc.). Until today, the World Bank has failed to analyze the problems which may be associated with the expansion of powerful transnational corporations into strategic industries in developing countries—though it can be shown that in many cases, the quality of services has declined and/or access to services been reduced after privatization (Saprin 2004: 114ff.). Since it is usually very difficult to reclaim regulatory power over industries once they have been sold to foreign investors, it can be concluded that FDI in strategic industries must be treated very carefully as it can severely restrain the freedom and sovereignty of developing country governments for years to come.

6. Negative Impacts of Increased Competition for Investment

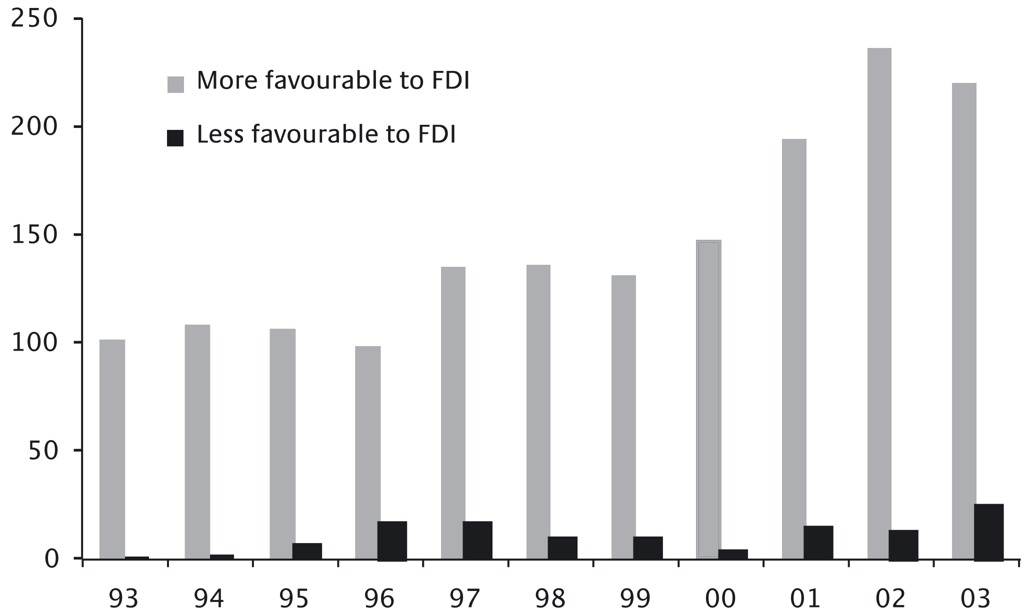
Lydia Krüger

The World Development Report 2005 rests on the assumption that improvements in the investment climate are the driving force behind growth and poverty reduction. In the following chapter, this hypothesis will be challenged by arguing that there is a basic contradiction between the goal of poverty reduction on the one hand and investor demands for lower taxes, lower wages, less regulation and privatization of basic services on the other.

While it is true that ever more developing countries have tried to attract FDI by abolishing regulations which have constrained the freedom of foreign investors (see Figure 6.1), it would be wrong to conclude that countries offering the loosest regulatory regime have also been able to attract the most FDI. On the contrary: During the 1990s, it was China—a country with a very restrictive FDI-regime—which attracted the largest share of FDI of any developing country, and has now become the second largest recipient of FDI in the world (UNCTAD 2003: 7). On the other hand, Africa's share of global FDI inflows fell from a mere 2.15% (1992) to an all-time low of 1.7% in 2002 (UNCTAD 2003: 33)—notwithstanding the fact that during the 1990s, most African countries »have liberalized regulatory regimes for FDI, addressing investors' concerns, privatizing public enterprises and actively promoting investment« (UNCTAD 2003: 36).

Figure 6.1: Changes in National Regulations of FDI, 1993-2003 Number of regulatory changes of which:

UNCTAD (2004): World Investment Report, p. 8



It can thus be argued that government strategies that focus on improving the investment climate are not always successful, since other aspects (access to large markets and / or natural resources) are usually more important for attracting FDI. On the other hand, there is a real danger that the quality of FDI will decline with increased competition for investment. The more governments try to improve their investment climate by reducing corporate income taxes and abolishing regulations and performance requirements, the smaller are the benefits from FDI for society as a whole.

In this chapter, we will focus on the following issues and questions:

- Investment Competition and Taxation: Does increased competition for investment between different jurisdictions lead to harmful tax competition which erodes the tax base of the state and prohibits necessary public investments in infrastructure?
- Investment Competition and Labor Standards: Does increased competition for investment lead to a »race to the bottom« in wages and labor standards? Do we need international rules for transnational corporations to counter the negative effects of investment competition on labor and environmental standards?

6.1 Investment Competition and Taxation

The development and expansion of multinational corporations, the deregulation of financial markets and the IT revolution have increased capital mobility, making it much easier for investors to take advantage of better economic opportunities abroad. In order to serve the interests of mobile investors and wealthy individuals, many governments have reduced taxes on capital—which include taxes on business profits (such as corporate taxes) as well as taxes on individual receipts of dividends, interest, and capital gains. The countries which were the first to push for an international regime of capital mobility by liberalizing capital accounts (Britain in 1973 and the US in 1979) were also the ones who sparked the move towards lower tax rates: Between 1982 and 1986, Britain cut its corporate tax rate from 52 to 35 percent, followed by the United States' Tax Reform Act of 1986, which reduced that rate from 46 to 34 percent (Edwards/ de Rugy 2002: 13).

Since 1980, average peak personal income tax rates in major industrial countries of the OECD has fallen by twenty percentage points, while average peak corporate income tax rates dropped by six percentage points between 1996 and 2002 (Edwards/de Rugy 2002: 1). Capital gains taxes and special wealth taxes were also reduced or abolished in numerous countries. According to a survey by the European Commission, the average interest income tax, financial wealth tax, and non-resident interest withholding tax have been almost halved since 1983 (Huizinga/Gaetan 2001: 19)—a development connected to the liberalization of capital movements and the fact that it is extremely difficult to get information from banks about bank deposits and other financial assets.

Nonetheless it would be incorrect to argue that investment competition generally leads to a reduction of tax revenue, thereby forcing cuts in public expenditure. According to Genschel (2002: 253), the reductions in the peak corporate and personal income tax rates has usually gone hand in hand with a broadening of the tax base, the elimination of tax shelters and a better enforcement of tax laws—at least in the developed countries. As OECD Revenue Statistics demonstrate, total taxes as a percentage of GDP actually rose from 32.1 percent in 1980 to 37.3 percent by 1999 in the OECD countries, and from 38.6 to 42.1 percent in the European Union (van den Noord/Heady 2001: 18).

Tax competition has thus not reduced the overall tax level in the industrialized countries. This is mainly due to the fact that many governments tried to shift the burden of taxation from capital to labor. In the developed countries and in many developing countries, the effective/implicit tax rate on labor has risen over the last decades with the consequence that some workers today receive only half of their gross wage earnings—the rest is paid to the government and used to finance social security systems.

High labor taxation and social security contributions, however, tend to increase inequality (especially when they are accompa-

Table 6.1: Income tax plus employee social security contributions* in selected OECD countries (as % of gross wage earnings), 2003

Country	Income Tax	Social security contributions	Total payment	Gross wage earnings**
Australia	24	0	24	37 396
Germany	21	21	42	35 480
Belgium	27	14	41	34 610
Switzerland	10	11	21	34 543
Netherlands	9	25	34	33 721
Korea	2	5	7	33 620
USA	16	8	24	33 459
United Kingdom	16	8	24	30 947
Japan	6	12	17	29 975
Italy	18	9	27	26 819
France	13	14	27	24 394
Spain	12	6	19	21 439
Turkey	15	15	30	15 305
Poland	6	25	31	14 511
Portugal	6	11	17	12 130

*Single individual without children at the income level of the average production worker
**Dollars with equal purchasing power Source: OECD

nied by tax cuts on capital and corporate gains) and spur the development of an informal labor market—a problem which tends to reinforce itself as the growth of such a shadow economy brings further losses of tax revenue. Genschel therefore comes to the conclusion that though tax competition does not lead to lower tax revenues, it is still harmful in the sense that it »prevents governments from raising taxes in response to rising spending requirements and from detaxing labor in response to growing unemployment« (Genschel 2002: 245).

6.2 Competition for Investment as the Main Cause of International Tax Dumping

Recent studies on the impact of taxation systems on foreign direct investment have come to the conclusion that direct investment flows are increasingly affected by tax systems. Countries which offer preferential tax regimes to foreign investors are able to attract more FDI than countries with progressive tax regimes (see for example Gropp/Kostial 2000 or Hines 2001). In Europe, for example, four tax havens or low-tax countries—Ireland, the Netherlands, Luxembourg, and Switzerland—accounted for only 9 percent of European GDP but attracted 38 percent of U.S. FDI to Europe between 1996 and 2000 (Sullivan 2002).

Though it can be argued that foreign direct investment in general is not very sensitive to tax differentials, certain activities such as intra-group finance, headquarter administration or financial services are very sensitive to taxation (Genschel 2002: 255). Since the share of FDI going to financial services has increased in recent years, it has become an attractive option for governments around the world to specifically target investment in tax-sensitive business activities. Luxembourg may be the best example for the success of such a strategy:

In 2002, this small country with less than half a million inhabitants was the largest recipient of FDI in the world—which is due to the fact that Luxembourg offers very favorable conditions for holding companies and for corporate headquarters, such as certain tax exemptions (UNCTAD 2003: 69). In neighboring Germany, a fifty-percent capital gains tax on sales of stocks in other companies was abolished in 2001 in order to attract foreign holding companies—a decision which even the EU criticized as »unfair tax competition« (Edwards/de Rugy 2002: 11).

The result of such strategies to attract FDI is that many large transnational companies no longer pay any taxes at all, since they have become experts in the manipulation of cross-border commercial and financial transactions. For example, TNCs use strategies such as transfer pricing (whereby affiliates in low-tax environments charge inflated prices for deliveries to affiliates in high-tax environments and pay deflated prices for deliveries they receive), thin capitalization (which means that subsidiaries in high-tax countries are financed by intracompany loans rather than equity, because interest expenses are tax-deductible while dividend payments are not) and the creation of holding companies in low-tax environments in which interest income is taxed lightly or not at all (Genschel 2002: 245).

But not only large corporations use tax havens to evade taxation—rich individuals do as well. According to the International Tax Justice Network, assets held offshore—beyond the reach of effective taxation—may equal one-third of total global assets. The world's largest private banking center, Switzerland, has accumulated $1.2 trillion in assets held by non-Swiss citizens (Forbes Magazine Jan. 9th 2003). And it has been estimated that German tax-evasion money invested in Swiss, Liechtenstein and Luxembourg bank accounts—i.e., capital flight money—amounts to €450—550 billion– a sum equivalent to one quarter of Germany's gross national product (Swiss Coalition 2001).

6.3 The Effects of Capital Flight and Tax Evasion on Developing Countries

As the OECD stated in its 1998 report on harmful tax competition, the »free riding« behavior of corporations which try to avoid taxes by moving parts of their businesses to countries with favorable tax regimes »may hamper the application of progressive tax rates and the achievement of redistributive goals« (OECD 1998: 14). If even the rich countries increasingly worry about the negative effects of international tax competition, it can be concluded that the problems facing developing countries will be even more severe. This is partly due to the fact that their institutions for effective tax administration are underdeveloped, with the consequence that tax revenue as a proportion of GDP is typically much lower in developing countries than in rich countries. According to an IMF study, tax revenue in developing countries amounts to only 18.2 percent of GDP, whereas the corresponding figure for OECD countries is 37.9 percent (Tanzi/Zee 2000: 8).

Since developing countries are often characterized by large informal sectors, a small share of wages in national income and a very uneven income distribution, it is even more necessary for them to apply progressive tax rates to mobilize sufficient resources. However, due to the concentration of economic and political power, richer taxpayers are usually able to prevent such reforms—which explains why personal income taxes and wealth taxes are rarely applied in the countries of the South (Tanzi/Zee 2000: 4). Moreover, the collective bargaining power of developing countries vis-à-vis foreign investors has eroded massively since the debt crisis and the spread of structural adjustment programs in the early 1980s. This may explain why the rates for taxes on profits paid by US multinational companies operating in the South dropped from an average of fifty-four percent in 1983 to only twenty-eight percent in 1996 (Swiss Coalition 2001). Today, few developing countries apply corporate tax rates in excess of twenty percent, since they fear relocation of investments if they raise such taxes too high. Though it is almost impossible to calculate the financial losses to developing countries associated with tax evasion, international competition to provide tax relief, and damaging tax practices, Oxfam has estimated that developing countries as a whole are losing annual tax revenues of at least US$50 billion—which is six times the amount needed to provide all the children of the world with a basic education, and three times the amount that would be needed to provide basic health care in all developing countries (Oxfam 2000: 1). Without strategies to combat tax evasion and international tax dumping, all efforts to alleviate poverty are therefore likely to fail.

6.4 Investment Competition and Labor Standards

It is often assumed that technological innovation (especially in transportation and in the information and communications industries) has made it easier for transnational corporations to split up and relocate their production, making them more flexible to respond to changes in competitiveness and comparative advantage. Thus, increased investment competition does not only erode the tax base of developing and developed countries, it also exerts pressure on wage levels, labor and ecological standards. Especially in the countries of the OECD, but also in those emerging market economies which are attempting to move away from labor-intensive sweatshop production, TNCs frequently threaten to close down plants if workers don't accept lower wages and/or longer working hours. Even if the management of the TNC does not really plan to relocate their plants, the mere threat to do so is often sufficient to force unions and workers to make »sacrifices« in order to maintain jobs. Thus, the bargaining power of transnational corporations has increased considerably in recent decades without any cross-border equivalent on the side of trade unions, which have lost bargaining power as a result of higher domestic unemployment.

The effects of increased competition for investment on labor standards and patterns of employment relations have been widely debated. Broadly speaking, there are two different approaches: The first—which might be called the globalization approach—argues that increased FDI in the developing countries and the resulting imports from these countries has led to falling wages for low-skilled workers and/or increasing unemployment in the OECD countries. According to this view, the increased mobility of capital and goods goes hand-inhand with factor price equalization, which means that relative wages of workers in advanced countries cannot remain above those of comparable workers in less-developed countries (see e.g. Wood 1994). On the other side of the debate are those who argue that the primary cause of unemployment and rising wage inequalities in the North does not lie in the competition from low-wage countries, but rather in various other factors such as technological innovation, which has led to a general increase in the productivity of manufacturing, reducing the necessary amount of labor power worldwide. According to this second approach—which may be called the institutionalist approach (Lansbury 2002)—labor standards are the result of (or shaped by) national institutions, economic structures and traditions.

The question as to whether increased competition for investment also leads to a »race to the bottom« in wages and labor standards in the poorer countries of the South is even more difficult to answer than it is for the industrialized countries. In some developing countries, governments try to attract FDI by lowering labor standards, and offer incentives to foreign firms that sometimes are so costly that the net benefit of the new investment is zero or even negative (Jauch 2002: 101). On the other hand, empirical research has demonstrated that the wages paid by foreign firms are usually higher than wages paid by domestic firms (Almeida 2004: 2ff.)—which may lead to the conclusion that FDI in the South reduces the income gap between North and South. Analyzing the Portuguese case, however, Almeida comes to the conclusion that though foreign firms pay higher wages than domestic ones, this is due to the fact that »foreigners ›cherry-pick‹ domestic firms, choosing those firms with an educated workforce and higher wages« (Almeida 2004: 6), Hence, FDI does not necessarily lead to wage increases.

Does FDI then, in sum, contribute to higher living standards in the South through job creation, higher foreign exchange earnings and the transfer of more advanced foreign technologies, or does it perpetuate underdevelopment and dependence through the transfer of wealth and profits generated by overexploitation of labor and national resources? The answer is that there is no clear answer: It depends on the specific circumstances. One major factor is the existence of so-called export processing zones (EPZs); since a large and growing part of FDI going to the South is located in these zones, the next section will focus particularly on their development impact. And since the issue of regulation of foreign direct investment to prevent the abuse of their power by the TNCs is central to the debate, section 6.6 will discuss the issue of corporate accountability by analyzing and comparing the different codes of conduct for TNCs which have been developed by international bodies such as the UN, the ILO and the OECD.

6.5 The Spread of Export Processing Zones (EPZs)

According to the International Labor Office (ILO), an EPZ is a »a delimited geographical area or an export-oriented manufacturing or service enterprise located in any part of the country, which benefits from special investment-promotion incentives, including exemptions from customs duties and preferential treatment with respect to various fiscal and financial regulations« (Romero 1995). Since in most cases, EPZs are special geographic zones which are exempted from certain rules and regulations which apply to the rest of the economy, EPZs can be compared to offshore financial centers such as the London International Banking Facility—with the difference that tax breaks, low tariffs for imported goods and other incentives are granted mainly to investors–and particularly to foreign investors—who set up industries for export production.

The World Bank's attitude toward EPZs is ambiguous: On the one hand, the establishment of EPZs is greeted as a first step towards full trade liberalization and interpreted as a positive signal that a country is moving away from a strategy of import-substitution towards a more export-oriented economy (World Bank 1991). On the other hand, the World Bank criticizes the fact that the liberalization of trade and capital flows is restricted to special zones, which also implies that restrictions on the free flow of capital are maintained in the rest of the economy. The creation of EPZs is thus viewed as a second-best option, whereas the goal should be to make the whole country operate like an EPZ (Jauch 2002: 101).

Since the first EPZ (the Shannon Free Trade Zone) was established in Ireland in 1960, the number of countries which set up EPZs in order to attract foreign investors has grown at an impressive rate: Whereas in 1970, there were only ten host countries (Romero 1995), their number rose to more than seventy in the mid-nineties and reached 116 in 2002. At the end of 2002, China alone employed about 30 million people in »over 2,000 special economic zones, economic and technological development zones, EPZs and border zones«(ILO 2003: 6).

But whereas the percentage of exports which come from (or move through) EPZs is usually high, in many cases amounting to over eighty percent of total merchandise exports (ILO 2003: 2), the number of employees working in such zones has remained quite small in relation to the total working population. It can thus be argued that the concentration of growth in EPZs does not contribute to high levels of net job creation, as these zones tend

Table 5: Estimates of the Development of Export Processing Zones

	1975	1986	1995	1997	2002
No. of countries with EPZs	25	47	73	93	116
No. of EPZs	79	176	500	845	3000
Employment (millions)	n.a.	n.a.	n.a.	22,5*	43*
- of which China	n.a.	n.a.	n.a.	18	30

*conservative estimate, covering 108 countries for which data are available
ILO (2003): Employment and social policy in respect of export processing zones (EPZs), p. 2.

to have weak links with the domestic economy (SAPRIN 2004: 107). Moreover, employment gains from EPZs can be easily reversed, as the Mexican example demonstrates where about 200,000 jobs in the maquiladora industries were lost between 2000 and 2002, due to the relocation of labor-intensive production to countries with even lower wages (ILO 2003: 6).

According to the UNCTAD, the contribution of EPZs to sustainable development in the South »depends very much on other policies, policies that go beyond incentives, and aim at enhancing human resources and creating the infrastructure necessary to attract and upgrade export-oriented FDI. There are zones that have been successful, as in China, the Dominican Republic, Mauritius and Singapore. On the other hand, there are many that have failed to attract substantial investment and where outlays have far exceeded social benefits…[in Kenya, for instance]« (UNCTAD 2002: 214ff.).

In this context the ILO has pointed to the fact that the ability of EPZs to upgrade skills, and to improve working conditions and productivity is often undermined by legal restrictions on trade-union rights, the absence of workers' organizations and/or the lack of enforcement of labor legislation. Since labor turnover is usually very high in EPZs, where the majority of workers are young women who are seldom employed for more than five years, it is usually very difficult to create and sustain workers' organizations which might engage in collective bargaining. In accordance with the institutionalist approach, it could therefore be argued that whether or not FDI leads to improved wages and working conditions depends on the strength of institutions representing workers in the EPZs.

6.6 Necessary Rules and Regulations for Transnational Corporations

From the early 1940s and culminating in the early '70s, developing countries fought for political as well as economic sovereignty, an issue closely related to the rights of Third World governments in relations with the foreign corporations which often controlled the strategic resources in former colonies. At the height of the north-south conflict in 1974, the General Assembly of the United Nations passed the Charter of Economic Rights and Duties of States which declares in Article 2 that

»…each state has the right

a. To regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities. No state shall be compelled to grant preferential treatment to foreign investment;
b. To regulate and supervise the activities of transnational corporations within its national jurisdiction, and to take measures to ensure that such activities comply with its laws, rules and regulations and conform with its economic and social policies. Transnational corporations shall not intervene in the internal affairs of a host state. Every state should, with full regard for its sovereign rights, cooperate with other states in the exercise of the rights set forth in this subparagraph;
c. To nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be paid by the state adopting such measures, taking into account its relevant laws and regulations and all circumstances that the state considers pertinent […]« (General Assembly of the United Nations 1974: Resolution 3281).

In contradiction to this effort to define the rights of Third World governments towards transnational corporations, several attempts were made during the 1990s to establish an international legal framework defining the rights of transnational corporations towards governments. The first such attempt was the proposed Multilateral Agreement on Investment (MAI), which was developed in secrecy within the OECD and included many controversial proposals such as the right of transnational corporations to sue governments if laws were enacted which reduced the profitability of an investment. After the MAI failed—due to resistance from France, from various NGOs and from developing country

[27] Available at URL: http://www.ilo.org/public/english/standards/norm/sources/mne.htm

governments—the effort to establish legally binding rights for TNCs continued on a multilateral level within the WTO and on a bilateral level by the negotiation of bilateral investment treaties (BITs), whose number quintupled during the 1990s (UNCTAD 2000).

Parallel to these efforts to define the legal rights of investors towards governments, some international organizations such as the ILO, the United Nations and the OECD have raised the issue of corporate governance and elaborated various codes of conduct for transnational corporations—the most relevant of which are:

The ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy,[27] (first adopted by the Governing Body of the ILO in November 1977) which sets out principles in the fields of employment, training, conditions of work and life and industrial relations;

The United Nations Global Compact[28] (proposed by UN Secretary-General Kofi Annan at the World Economic Forum on 31 January 1999), which tries to promote »responsible corporate citizenship« based on ten general principles[29] in the areas of human rights, labor and the environment;

The OECD Guidelines for Multinational Enterprises[30] (adopted by 29 OECD member countries as well as Argentina, Brazil, Chile and the Slovak republic in June 2000) where the responsibilities of TNCs with regards to labor relations, the environment, consumer protection, use of technology, competition and taxation are addressed in form of various recommendations;

The Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights[31] (adopted by the Sub-Commission on the Promotion and Protection of Human Rights of the UN Human Rights Commission in August 2003) which do not create any new legal obligations, but »provide a succinct, but comprehensive restatement of international legal principles applicable to business concerning human rights, humanitarian law, international labor law, environmental law, consumer law and anti-corruption law.«[32]

According to a study by Kolk, van Tulder and Welters (1999), the probability of TNCs' complying with these codes of conduct depends on their content (How precise are the codes? Is it easy to measure them?), and on the compliance mechanisms (Is there systematic monitoring of compliance with them? Do specific sanctions exist for those who do not comply?). However, the general problem with all these codes of conduct is that those which include enforcement provisions are often so vaguely formulated that it is difficult to decide whether sanctions should be imposed or not; and that comprehensive codes which are precisely formulated usually include no enforcement provisions.

The only way to overcome these difficulties is to increase public pressure on TNCs which behave in an irresponsible way—a strategy which has been quite successful in a number of cases (for example Nestlé or Shell), since TNCs usually have a great interest in maintaining a positive public image.

[28] See URL: http://www.unglobalcompact.org

[29] Initially there were only nine principles; in June 2004 the Secretary-General announced the addition of a tenth principle against corruption.

[30] Available at URL: http://www.oecd.org/dataoecd/56/36/1922428.pdf

[31] U.N. Doc. E/CN.4/Sub.2/2003/12/Rev.2 (2003). Available at URL: http://www1.umn.edu/humanrts/links/norms-Aug2003.html#approval

[32] See the Joint Civil Society Statement on the Global Compact and Corporate Accountability. URL: http://www.corporate-accountability.org/news/Global_Compact_Statement-Signed.pdf

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7. Bangladesh's Experience with Foreign Direct Investment

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7.1 Introduction

Bangladesh remains an interesting case among the Least Developed Countries (LDCs) to be studied from the vantage point of foreign direct investment (FDI) behavior. Bangladesh is distinguished among the LDCs because of its relative success in economic and social development. It continues to record moderately high real economic growth (5 percent plus annually), with macroeconomic stability characterized by low inflation rate (4-5 percent) and a controlled fiscal deficit (less than 4.5 percent of GDP). The country experienced steady double-digit export growth over the last decade and a half, reaching about $6.5 billion in 2004. At the same time, foreign remittances flowing in from Bangladeshi migrant workers have trebled, rising to $3 billion per annum during the same period. Over the years, the country has achieved the food grain production capability sufficient to feed its population of 140 million. Concurrently, Bangladesh has improved its human development indicators, underpinned by a falling population growth rate.

Thus, a case study on Bangladesh is quite instructive both in terms of understanding the potentials and grasping the limits of the impact of FDI in the development process of low-income countries. It is a matter of further interest to explore the role of FDI in poverty alleviation as the country finalizes its Poverty Reduction Strategy Paper (PRSP).

At the time of independence in 1971, Bangladesh inherited only a small stock of foreign direct investment (FDI), most of it by TNCs, and geared toward exploiting a domestic market protected by the then-prevailing import-substitution policy. Some of it controlled the country's tea plantations. There were also a number of foreign banks and insurance companies operating in the country on the eve of independence.

Since then, Bangladesh has been trying to attract foreign investment to underwrite its savings-investment gap as well as to redress its export-import imbalance. To this end, the country has over the last two decades deregulated and liberalized its foreign investment regime. This has been done largely under a World Bank and IMF-backed Structural Adjustment Policy (SAP) package. Moreover, with a view toward encouraging the flow of FDI, Export Processing Zones (EPZs) were established. The capital markets were allowed to receive foreign portfolio investments in both primary and secondary markets.

Notwithstanding the dominance of such a liberal policy regime, FDI has largely continued to shy away from Bangladesh. Per capita FDI inflow has remained at less than $2. As noted above, an inviting policy framework is certainly no guarantee for enhanced FDI flow. Rather, there are a number of important preconditions for ensuring investment flow from either foreign or local sources, and macroeconomic stability is high on the list. Moreover, supply-side factors ranging from physical infrastructure facilities through human capital availability to natural resource endowment greatly define the initial conditions for attracting FDI. The cost of doing business in the host country, particularly relating to market intermediation and contract enforcement, is also one of the single most important factors determining the flow of FDI.

However, the policy space for steering FDI into priority sectors has gradually been vanishing in developing countries. In the recent past, a number of new issues, viz. »capital account convertibility« promoted by the IMF, »Trade and Investment Policy« of the so-called Singapore Issues of the WTO, and the concept of Corporate Social Responsibility (CSR), have been introduced to the policy debate on FDI. The relevance of these issues is also being discussed in Bangladesh, within the contextual of that country's realities.

The present paper briefly focuses, in the example of Bangladesh, on a number of aspects of FDI. These include the policy regime for the FDI (discussed in the next section), the general features of the FDI flow (Section 3), impact of the FDI flow on Bangladesh (Section 4) and its poverty-alleviating possibilities (Section 5). In the last section, the main findings will be summed up by presenting a critical assessment of the role of FDI in fostering development and reducing poverty.

7.2 Policy Framework for FDI

The Regulatory Framework for FDI. Efforts to attract FDI in Bangladesh are anchored in an overall framework of policies that seeks to create a favorable environment for a market-friendly, private-sector-led development. To this end, since the beginning of the 1980s, Bangladesh has adopted a number of measures to facilitate the expansion of the private sector and increase the inflow of foreign investment.

Under the country's current Industrial Policy, adopted in 1999, the private sector has been recognized as the »engine of growth.« With the exception of a few reserved sectors[33], the entire economy has been opened, with no ceiling for private-sector engagement. Private investment is defined as both local and foreign, including joint ventures between local and foreign companies, or with the public sector. Bangladesh as a founding member of the WTO, has committed itself in its Industrial Policy (1999) to the Most Favored Nation clause as well as to National Treatment for foreign investors.

The policy framework for foreign investment in Bangladesh is based on two basic pieces of legislation, the Foreign Investment (Promotion and Protection) Act, 1980 and the Bangladesh Export Processing Zone Authority (BEPZA) Act, 1981. Whilst the first defines the scope and space for FDI in Bangladesh, the latter addresses especially the provisions for FDI in the EPZs.

Investment Protection. Protection against expropriation of foreign investment takes the form of guaranteed compensation laid down in the Foreign Private Investment (Promotion and Protection) Act of 1980. If a foreign investor is subjected to a legal measure that has the effect of expropriation, adequate compensation will be paid, and the investor will be free to repatriate it. The amount of compensation will be determined by apprising the market value of the investment immediately before the measure went into effect. However, there has been no instance of expropriation of foreign property since the Act was passed in 1980. Risks of expropriation are almost nil, as the country avowedly follows the principles of a free-market economy.

Bangladesh is also a signatory of the Multilateral Investment Guarantee Agency (MIGA), which insures investors against political risk. The insurance and finance programs of the USA, including the Overseas Private Investment Corporation (OPIC), are operable in Bangladesh. Bangladesh is also a member of World Intellectual Property Organization (WIPO) and the World Association of Investment Promotion Agencies (WAIPA). Hence, property and other rights of foreign investors are safeguarded according to international standards.

Bangladesh provides risk coverage to exporters who can take out several types of hedging under the Export Credit Guarantee Scheme. These also include the export payment risk policy and the whole turnover pre-shipment finance guarantee.

Equity Requirement and Repatriation. There is no cap on either minimum or maximum levels of equity for FDI in a private enterprise in any sector. Foreign investors are allowed to repatriate not only their dividends and profits, but also the sale proceeds of their stocks, with permission of the Central Bank. However, there is no recorded case of the Cen-

[33] These are production of arms, ammunitions and other defense equipment and machinery; nuclear energy; forest plantation and mechanized extraction within the bounds of reserved forests; security printing (currency notes) and minting; and railways.

tral Bank's refusal to permit repatriation of revenues from a stock sale.

Local Content Requirement. There is no general local content requirement for foreign investment in Bangladesh. Industries are free to use raw materials procured locally or imported at competitive prices. However, in the case of the pharmaceutical industry, raw materials for some drugs have to be locally procured. The government also encourages the use of local raw materials in garments and some other non-traditional exports, by providing either cash compensation or duty-drawback facilities applicable to export items.

Technology Transfer. There are no general technology transfer requirements binding on all FDI. There are some sector specific technology transfer requirements. For example, contracts signed with the international oil companies (IOCs) stipulate the transfer of technology to the national oil company, Petrobangla, including regular training to develop local human capabilities, and of the hand-over of some heavy machinery after conclusion of the contracted work etc.

Environmental Standards. Investors are required to conform to certain environmental safety standards, and to obtain clearance certificates from the Department of Environment. These standards include the installation of appropriate water-treatment plants, air pollution control devices, noise pollution, safety measures, etc.

Dispute Settlement Mechanism. Bangladesh follows standard legal dispute settlement procedures arising in course of business transactions and investment. Investors can take seek redress in court in case of disputes with either the government or any private party. If they feel that their rights have been violated, they can file writs with the High Court.

For labor disputes, investors can appeal to the Labor Court for remedy. Forty-seven labor laws are in effect In Bangladesh, covering wages and employment, trade unions and industrial disputes, working conditions and labor management, and related matters. For settlement of industrial disputes, contracts or agreements are usually made between management and a collective bargaining agent under the Industrial Relations Ordinance, 1969. Bangladesh has signed and ratified all the major ILO conventions on labor rights. Recently, the right to freedom of association is being phased in in the EPZS.[34]

Bangladesh has also signed the World Bank's Convention on the Settlement of Investment Disputes between States and Nationals of Other States, which provides for the international arbitration of disputes between foreign investors. Arbitration facility of the International Center for the Settlement of Investment Dispute (ICSID) is also available in Bangladesh.

Fiscal Incentives to Non-Resident Bangladeshis. Investment by non-resident Bangladeshis (NRBs) falls into the category of FDI, and is treated accordingly. However, there are special incentives provided to encourage investment in the country by NRBs, which other foreign investors do not enjoy. NRBs can purchase Initial Public Offerings (IPO) of Bangladeshi companies on the capital market, where a quota of ten percent of primary public shares has been reserved for them. Furthermore, like other foreign investors, NRBs can maintain foreign currency deposits in non-resident foreign currency deposit accounts.

Exchange Rate Regime. Bangladesh successfully floated its national currency in May 2003. While there is convertibility in the current account, Bangladesh is cautiously approaching the issue of capital account convertibility.

Bilateral Trade and Taxation Agreement. Bangladesh has also entered into investment and taxation agreements with a number of countries. It has bilateral treaties on investment promotion and protection with twenty countries—primarily with OECD countries, a few Eastern European countries[35] and some Asian countries.[36] Negotiations are on-going with a considerable number of other countries. There are also treaties for avoidance of double taxation, also with these countries. However, evidence suggests that there is practically no

34 This include freedom of association and collective bargaining (Conventions 87 and 98), elimination of forced and compulsory labor (Conventions 29 and 105), elimination of discrimination in respect of employment and occupations (Conventions 100 and 111), and abolition of child labor (Conventions 138 and 182). Bangladesh has ratified all but the Convention on Minimum Age (Convention 138).

BOX 7.1: FDI POLICY FRAMEWORK IN BANGLADESH

Policy Areas	Facilities
Nodal Institutions	Board of Investment, Export Processing Zone Authority
Protection & Guarantees	Financial compensations in case of nationalization, expropriation, and equitable treatment under: - Foreign Private Investment (Promotion and Protection) Act - Bilateral guarantees Signatory to: - Multilateral Investment Guarantee (MIGA) - International Convention for the Settlement of - Investment Disputes (ICSID) Commitment to protection of intellectual property rights
Equity Participation	Up to 100 percent ownership by foreign investor
Repatriation of Capital	Repatriation of capital and dividends allowed
Fiscal Incentives	- Tax holidays for industries located in free trade zones (3-7 years depending on their location) - Reduced import duties on capital machinery and spare parts - Tax exemption on royalties, interest on foreign loans, and capital gains from the transfer of shares - Duty-free imports for 100-percent exporters
Infrastructural Incentives	- Export-Processing Zones - Relatively lower price of land in industrial estates/areas with electricity, gas, water, sewerage etc.

Source: Bhattacharya D. (2002)

congruence between existence of a bilateral investment agreement or a double taxation treaty with a country, and the flow of FDI from that country.

Bilateral and Regional Trade Accords. Bangladesh is a member of a number of regional and sub-regional cooperation agreements. These include the South Asia Preferential Trading Agreement (SAPTA) and the Bangladesh, India, Myanmar, Sri Lanka and Thailand Economic Cooperation (BIMSTEC). The country is participating in the operationalization of the framework agreement on a South Asia Free Trade Area (SAFTA). A number of bilateral trade agreements with neighboring countries, including India, are also being explored. Bangladesh will soon complete talks on signing a Trade and Investment Framework Agreement (TIFA) with the USA. FDI in Bangladesh can take advantage of the market access facilities provided under these agreements to export to partner countries, by fulfilling the Rules of Origin requirements.

The foregoing review indicates that Bangladesh, with a view toward providing an enabling investment climate for FDI, has put in place one of the most open policy regimes in the developing world. Empirical evidence presented in the following sections will reveal that a willing, able and credible government

[35] Including Belgium, France, Germany, Switzerland, Italy, Japan, the UK and the US, as well as Poland and Romania.

[36] Such as China, the Philippines, South Korea, Indonesia, Thailand, Malaysia, Pakistan, Iran and Turkey.

together with a generous policy package has been translated into hardly any real returns in terms of FDI flow, as promised by international organizations like the World Bank or the IMF. With no distinction between foreign and local investment, the *WDR 2005* in Chapter 1, Page 1.5 states that an investment climate is characterized by three interrelated aspects: barriers to competition, risks and costs. Commensurate with its general level of (under)development, Bangladesh has sought to address these three sets of factors, but to little avail.

Bangladesh has almost done away with all entry and exit barriers for foreign investors, and has signed all international »arrangements that reduce regulatory barriers to international trade and investment« (*WDR 2005,* Chapter 9, p. 9.1). As regards »risks,« the country has, among other things, consolidated macroeconomic stability, demonstrated predictability of policy, and provided full protection to foreign investment. As regards the »costs,« tax exemptions in Bangladesh are generous, and marginal tax rates are competitive, tariff levels are lower than in comparable countries, intervention in the labor market is minimal, etc.

It is true that transaction costs are often high in Bangladesh because of rent-seeking behavior of elements in the state apparatus. Also, infrastructural weaknesses impose extra costs on investors, and certainly, the acrimonious nature of domestic politics also creates some uncertainties. However, the international finance institutions (IFIs) have constantly argued throughout the »decade of structural adjustment« that deregulation, privatization and liberalization constitute the panacea for investment promotion and economic growth. Now, possibly wiser with hindsight, they have begun to highlight the role of institutions and, more recently, good governance.

7.3 Salient Features of FDI Flow

Debate on FDI Data. There are no reliable estimates in Bangladesh relating to FDI performance. A debate on differing accounting practices observed by the Board of Investment (BOI), the investment promotion agency of the country and the Bangladesh Bank, the central bank, continues in the country. On the one hand, there is a systematic tendency by the BOI to inflate investment figures; on the other hand, FDI flow remains underreported in the balance of payment (BOP) statement of the Bangladesh Bank, which often does not fully record capital machinery brought in, reinvested earnings or inter-company loans under appropriate heads. Curiously, the current BOP accounts also do not include foreign investments in EPZs. However, the central bank still remains the final authority for confirming FDI estimates using the IMF methodology.

In the following, we will discuss the tendencies, structure, sources and composition of FDI flow to Bangladesh, drawing on evidence from various sources. We will also discuss the export and employment implications of FDI in the country.

7.4 Inflow of Foreign Investment

As Figure 1 shows, Bangladesh has had fluctuating fortunes regarding FDI and portfolio-investment flows. Its extreme dip, a net outflow of more than $62 million in 1996-'97, followed the crash of the capital market, when the hot money brought in by portfolio investment rushed out again, wiping out domestic liquidity. Conversely, in 1997-'98, the economy registered its highest inflow (about $321 million), caused by major international oil companies investments following the discovery of new natural gas wells. Since then, foreign investment has stabilized at a low level.

Following a drop from the peak in FY98 (about $321 million), the decline was reversed in FY03, and indications are that a further rise in FY04 is likely. However, as Table 1 shows, the FY03 figure is still far below the historic high of FY98.

Estimates on the basis of BOP data on FDI and portfolio investment as well as foreign investments in EPZs indicate that a net total of $196.63 million in foreign investment came to Bangladesh during FY'03. Of total inflows, almost 47 percent (or $94.9 million) came as FDI in the domestic tariff area (DTA), and another 53 percent (or $103.13 million) in the EPZs. Portfolio investment remained marginal. Net inflow of FDI saw robust growth of about 42 percent in FY03, while foreign investment in the EPZ recorded an impressive 85 percent in-

Table 7.1: NET INFLOW OF FOREIGN INVESTMENT (in million US$)

Year	FDI			Portfolio Investment			Foreign Invest-ment in EPZs	Total Net In-flow of Foreign Invest-ment	Net In-flow of FDI as percent of GDP	Net FDI Inflow as percent of Priv.-Sector Invest-ment	Per Capita FDI In-flow (in US$)
	In-flow	Out-flow	Net In-flow	In-flow	Out-flow	Net In-flow	(Net In-flow) a				
FY97	17	1	16	16	148	-132	53.88	-62.12	-0.15	-1.07	-0.51
FY98	273	24	249	14	11	3	68.82	320.82	0.73	4.77	2.59
FY99	200	2	198	3	9	-6	70.61	262.61	0.57	3.71	2.08
FY00	194.4	0.8	193.6	10.7	10.6	0.1	34.98	228.68	0.49	3.11	1.79
FY01	166.1	0.1	166	5.9	6.3	-0.4	48.41	214.01	0.46	2.88	1.65
FY02	65.24	0.56	64.68	0.5	6.09	-5.59	55.71	114.8	0.24	1.44	0.87
FY03	94.9	3	91.9	2	0.4	1.6	103.13	196.63	0.39	2.24	1.47

a: Includes investments in joint-venture enterprises with local entrepreneurs.
Source: CPD Database

crease, continuing the recovery since the drop in FY00.

The observed trends reveal that the share of EPZ in annual inflow is growing, while the share of portfolio investment is still marginal. However, it is well accepted that FDI in the domestic tariff area is usually the best-quality foreign investment.

FDI in the EPZs is mainly motivated by financial incentives conceded by the government, and focuses on import and re-export of technically low-level products with marginal added value for Bangladesh. Therefore, if any foreign investment in Bangladesh have a potential for offering the potential benefits often attributed to FDI, such as technical upgrading or improving the quality of locally produced goods and services, then it is foreign investment in non-EPZ areas. However, investment in these areas is largely restricted by lack of infrastructural facilities including ready availability of industrial plots and the supply of utilities (e.g. water, gas, electricity and telephone connections). Until recently, a prohibition on trade union activities in EPZs was seen as an advantage.

WDR 2005, in Chapter 8, Page 8.12, refers to EPZs as one of the ways of improving the investment climate in a difficult environment, but concedes that benefits from enclave approaches are inherently limited. The major determinant of the relative success of EPZs in Bangladesh is the preferential trade access the country enjoys in the developed countries' markets as an LDC.

7.5 Structure of FDI

As may Table 2, shows, total FDI inflow in 2003 was US$432, of which equity amounted to forty-six percent.[37] Intra-company bor-

TABLE 7.2: GROSS FDI INFLOW IN BANGLADESH DURING 2003

Description	2002 (Jan-Dec)	2003 (Jan-Dec)	Growth (percent)
Equity	133.8	198.36	48.3
Reinvestment	116.8	186.47	59.6
Intra-company borrowing	77.7	46.97	-39.5
Total	328.3	431.8	31.5

Source: Bangladesh Economic Review 2004.

rowing comprised about eleven percent, and reinvestment accounted for a little above forty-three percent of total investment. Foreign direct investment in calendar year 2003 increased by 31.5 percent, largely due to an increase of about sixty percent in reinvestment of profits of existing companies.

7.6 Sources of FDI

The analysis of the sources of FDI in the DTA based on information presented in Table 3 shows that Norway tops the list, with about nineteen percent of FDI inflows in 2002, the most recent year for which data is available. However, the large Norwegian share is explained by one single project in the telecom sector.[38] Next come the USA (17 percent) and Singapore (14 percent), while Hong King and Malaysia account for nine percent each (see Figure 2).

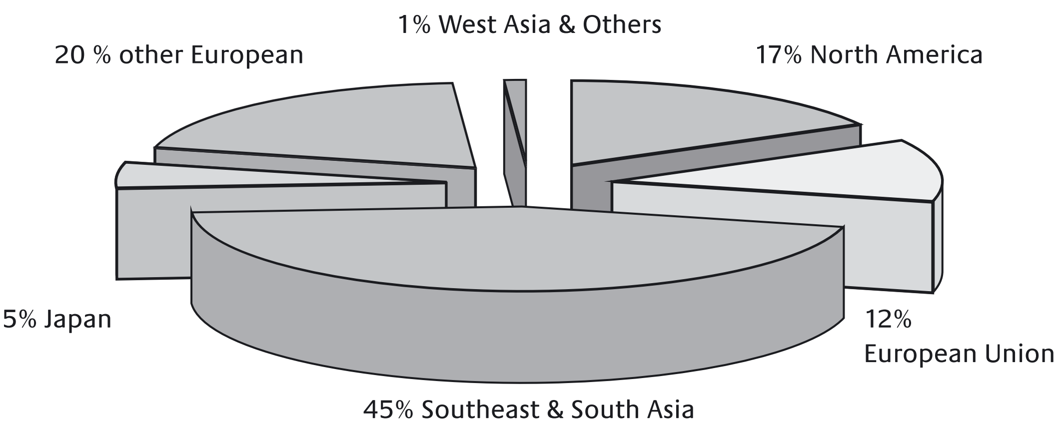
US investments are concentrated in service sectors like power generation, oil and gas, liquefied petroleum gas (LPG) bottling, health-care services, etc. The composition of the US investment indicates that it is predominantly oriented toward natural resources, as the bulk of the US investment is related to oil and gas exploration.

Members of the European Union and other European countries (i.e. Norway) accounted for about 32 percent of total FDI inflow in 2002. Their investments ranged throughout the manufacturing and service sectors, and included textiles, cement, agro-chemicals, leather goods, drugs and pharmaceuticals, etc. European investment has experienced a historic evolution due to its colonial past. As a result, European investment has a two-fold aim: market seeking (largely targeting the expanding domestic market), and efficiency growth (basically use of cheap but profitable labor).

Investments from southern, eastern and southeast Asian countries like China, Hong Kong, India, Malaysia, Pakistan, Singapore, Sri Lanka, Taiwan and Thailand are concentrated in the manufacturing sector. The share of these countries accounted for forty-five percent of total FDI inflow in 2002. Unlike the SAARC region, investment from the eastern and southeast Asian regions is gradually picking up, as they seek both new markets within Bangladesh and export markets using tariff preferences provided by various OECD countries to Bangladesh as an LDC.

Hence, the southeastern and eastern Asian countries dominate the investment flow to the EPZs in Bangladesh, which are not included in Table 3.

Figure 7.1: FDI Inflow by Sources in 2002 (excluding EPZs)



Source: BOI (2002)

37 This figure is for calendar year 2003, whereas the FY03 figure is $196.3 million. That means that FDI flow increased from July-December 2003.

38 Grameen Phone Ltd., a joint venture with the Norwegian company Nortel, is the largest mobile phone company in the country.

TABLE 7.3: TOP TEN SOURCES OF FDI INFLOW 2002 (excluding EPZs)

FDI Source Country	Enterprises		Investment	
	Number	Percent	Million US$	Percent
Norway	2	0.68	52.49	19.08
USA	25	8.45	46.17	16.78
Singapore	12	4.05	39.4	14.32
Malaysia	10	3.38	25.74	9.35
Hong Kong	20	6.76	23.75	8.63
UK	41	13.85	21.92	7.97
South Korea	32	10.81	13.55	4.92
Japan	21	7.09	12.61	4.58
India	23	7.77	11.02	4.00
China	16	5.41	6.92	2.51
Other Countries	94	31.76	21.59	7.85
Total	**296**	**100.00**	**275.15**	**100.00**

Source: BOI (2002)

7.7 Sectoral Distribution of FDI Inflow

A qualitative change in the FDI picture has been apparent recently. In the past, FDI in the DTA was partly understated, as already existing flows into the manufacturing sectors were listed mainly in power and energy, while 2002 statistics provide a diversified picture, in which the manufacturing sector has captured the major share, i.e. 44 percent of FDI (Figure 3). This indicates that the general interest of investors is growing, as they find both the domestic market and export opportunities more favorable for them. However, the change in the composition of FDI inflows, from the energy sector to the manufacturing sector, is also due to a government decision to deny cross-border export rights of natural gas to international oil companies.

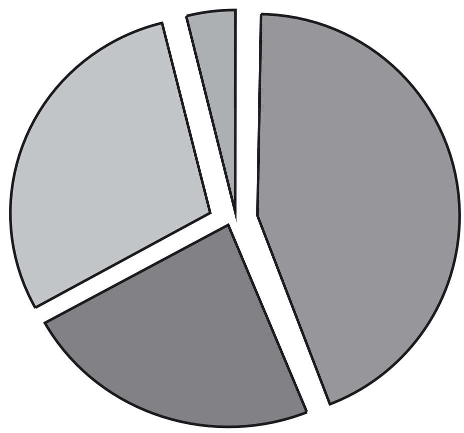
FDI and the Export-Import Scenario
By definition, all enterprises in the EPZs are export-oriented. Table 4 shows that EPZs in Bangladesh are gradually moving upward in terms of their share of the country's total exports. Between 1997 and 2003, the contribution of EPZs to national exports increased from about 10.5 percent to about 18.5 percent. Including the export value of foreign companies located in the DTA, the total contribution of FDIs will not be less than a quarter of the total export receipts of Bangladesh.

Foreign enterprises have also precipitated a change in the import structure of the country. Given that only a small part of the foreign firms are processing local resources (e.g. natural gas or agro-based raw materials), these investments remain overwhelmingly import-dependent. This dependence ranges from acquisition of capital machineries to sourcing of intermediate inputs and industrial raw materials.

One wonders to what extent the foreign exchange receipts due to the inflow of FDI is counterbalanced by enhanced import demand attributable to FDI. In the absence of any empirical evidence in this regard, it might be noted that foreign firms often import their capital machinery as equity contribution. The imported intermediate inputs and raw materials in processed form are either exported, or substitute for possible imports of finished products. However, as we will discuss below, the major balance-of-payments impact of FDI comes from remittances of profits and dividends.

We will also discuss the employment consequences of FDI in Bangladesh in the following section.

Fig 7.3: Sectoral Distrution of FDI (excluding EPZs)



Source: BOI (2002)

As stated above in the discussion of salient features of FDI, net annual inflow of FDI to the country has recently been in the neighborhood of $400 million, with per capita flow dropping to less than $1.5. More than half of total foreign investment flow is concentrated in the EPZs. Foreign investors are increasingly investing in the manufacturing sector. The single most important source of FDI in Bangladesh is reinvested earnings. The composition of the countries of origin of FDI in Bangladesh shows a domination by countries in East Asia and Southeast Asia. FDI contributes about a quarter of total export receipts of the country. Foreign firms provide 1.5 percent of national manufacturing employment.

Given the limited role of FDI in the national economy in Bangladesh, the generous incentive package on offer for the foreign investors seems a bit curious. But, benefits of FDI are more intangible than tangible, an appreciation of which may be generated by way of an analysis of the impact of FDI.

7.8 Impact of FDI

An increasing flow of FDI was supposed to supplement domestic investment in the country, thereby inducing employment generation, income growth and enhancement of prosperity. FDI potentially generates both direct and indirect impacts, some of which are elaborated below.

A) Direct Impact

Our examination of the direct impact of FDI in Bangladesh will concentrate on three issues: balance of payments, employment consequences, and revenue impact.

Balance of Payments Support. While FDI facilitates capital formation in the country, it may also create pressure on the balance of payment through repatriation of profits. As overall foreign investment was comparatively insignificant in Bangladesh, the impact of repatriation remained manageable. To keep this pressure within tolerable limits, Bangladesh has tried to encourage foreign investment in export-oriented industries. Total repatriation of profit, dividends and royalties on account of foreign investment in FY03 was $266.01million, which is around $70 million higher than the net inflow of FDI for the same year. Thus, a capital-starved country turns out to be a net exporter of capital. Of course, it is also necessary to take into account the indirect effects of FDI on the import bill and export revenues to assess the net impact of FDI on the balance of payments. In case of the import bill, FDI may have two contradictory effects. It may induce spending of more foreign exchange to meet in-

Table 7.4: The EPZs' Share of National Exports

Financial Year	Total Exports from Bangladesh	Total Exports from EPZs	EPZs as Percent of Total Exports
1997	4418	463	10.48
1998	5161	636	12.32
1999	5313	712	13.40
2000	5752	891	15.49
2001	6467	1068	16.51
2002	5986	1077	18.00
2003	6548	1200	18.34

Source: CPD Database

cremental import bill; and it may also save foreign currency through efficient import-competitive production.

Employment Situation. Due to scarcity of data on non-EPZ employment, it is difficult to draw a complete picture relating to employment generation impact of FDI. A recent study by FICCI in 2004 had the goal of ascertaining the size of employment by foreign companies in the domestic tariff area. According to this survey, a total of 129,549 persons were employed in foreign firms in the DTA, accounting for 0.68 percent of total manufacturing employment of Bangladesh. The highest share of workers in foreign companies was employed in the consumer-goods and apparels industries.

In the EPZs, the number of workers increased from about 130,000 in FY03 to 140,050 in FY04, which is about 0.74 percent of country's total manufacturing employment. In all, foreign companies (EPZs and domestic tariff area together) have generated about 2.7 million jobs, which accounts for less than 15 percent of total manufacturing employment. This indicates that FDI fails to play any prime role in employment generation in Bangladesh.

Apart of the fact that employment opportunities created by foreign firms are modest, it is important to note what kind of employment is generated by FDI in Bangladesh. The overwhelming share consists of low-paid jobs with unskilled labor, with a relatively low effect on the local economy. However, this is possibly particularly true of the EPZs. In foreign firms in the non-EPZs areas, a significant portion of middle and top management positions are filled by local professionals, and there are more highly paid jobs skilled jobs with more positive effects on the local economy.

Revenue Impact. Foreign investors are a potentially important source of revenue for host countries, and these revenues can in turn support economic and social development through increased public investment. It has been estimated that foreign investors in Bangladesh are paying around $13.20 million annually to the government exchequer[39]. However, much revenue-earning opportunity is often lost due to excessively generous incentive packages offered to FDIs, as described in Section 2. Thus, it is important for policymakers, guided by the need to maximize fiscal revenues, to balance their desire to attract and keep foreign investment beyond the tax holiday period against the interests of fostering a more substantive competitive strength of the economy.

B) Indirect Impact

Technology Transfer. The degree of technology transfer through FDI is an important measure of impact. While many cutting-edge technologies are not brought onto the market, developing countries have increasingly come to consider investment as one of the most important means of acquiring knowledge and upgrading their domestic production base, as well as improving the environment. It is difficult to measure the benefits of technology

[39] Data on FDI is received from the ongoing survey by Foreign Investors' Chamber of Commerce & Industry (FICCI) .

transfer without going into project-level case studies. It is well known that short-term and long-term effects differ, and that private benefits can diverge from social ones.

A survey to assess the state of competitiveness environment in Bangladesh conducted in 2003 by CPD for the World Economic Forum (WEF) revealed that a steady and overwhelming portion (86.5 percent) of respondents believe that technology in the country lags behind that in most other countries. An increasing share of respondents stated that FDI is an important and potential source of new technology in Bangladesh. However, they also acknowledged that in fact, technology transfer attributable to FDI had been very modest. This is largely because most of FDI, as mentioned above, generates low-quality jobs (e.g. in the apparel sector) and in the overwhelming majority of cases, FDI (particularly in the EPZs) is not integrated into a broad base of local suppliers. The rare incidences of transfer of technology and/or know-how may occur in the banking sector, pharmaceuticals, textiles, agro-based industries and construction. It may be also mentioned that in some cases reverse-engineering and mobility of labor constitute important methods of technology and skill transfer.

Market Intelligence. The consensus view on the linkages between FDI and foreign trade has changed somewhat over the past decade. Most importantly, imports, exports and allocation decisions by TNCs form integral parts of an increasingly international system of production of goods and services. The fact that sharply higher shares of industrial input goods are imported by the foreign companies illustrates the point that TNCs increasingly rely on trade in raw materials and input goods within sister enterprises to maximize profit through transfer pricing. For example, South Korean investors who came to Bangladesh in late 1980s to utilize the textile quota under the Multi-Fiber Arrangement (MFA) instilled significant market intelligence. Thus, we observe that in the last two decades local entrepreneurs in a vastly expanded scale have imitated the South Koreans and set-up production processes and established overseas market linkages to sell their products.

Foreign investments in pharmaceuticals, energy and cement production are a few other manifestation of generating market intelligence in the country. Local enterprises in these sectors have followed foreign investors in sourcing their machinery, accessing imported raw materials and marketing their textile products.

Competition. The relationship between FDI and corporate sector competition is complex. Clearly, the entry of foreign competitors in and of itself acts to spur competition, particularly in economies where competition policies are weakly enforced and market incumbents assert undue influence on pricing.

Competition with foreign investment also enhances efficiency within the country, leading to improvement in product quality. These efficiency gains are generated through enhanced labor and capital productivity as well as increased efficiency. These gains ultimately underpin improvements in product quality and decreases in unit prices. Trends in the toiletries and household chemicals sector, which is dominated by a number of TNCs (e.g. Lever Brothers), support the above-mentioned observations.

However, as the TNCs through various market-capturing tactics including predatory pricing policies, acquire an overwhelming market share, many small and medium-sized local enterprises are gradually forced out of the market. Hence, with more competition because of enhanced FDI flow, Bangladesh's economy ends up showing a tendency of concentration with regard to productive capacities due to displacement effects which mainly affect local producers. Furthermore, this displacement effect implies a change in ownership.

Corporate Social Reasonability. Maximization of shareholder value through corporate philanthropy is important in the present context. There are still debates as to how much firms can worry about things which are beyond their basic motive of profit generation. But some firms may do it to protect their interests by providing regular health care for their workforce, although from the point of view of workers as expressed in the survey of the CPD, there are only a few companies in Bangladesh which comply with health and safety standards (see Box 1).

Box 7.2: CORPORATE RESPONSIBILITY IN BANGLADESH: AGENDA FOR CONVERGENCE

The Centre for Policy Dialogue (CPD) carried out a benchmark survey on Corporate Responsibility Practices in Bangladesh: Results from a Benchmark Study between February and April 2002. The study revealed variations of perceptions about corporate responsibility by the major stakeholders in the Bangladesh context. Civil Society has negative attitudes and perceptions in general about the corporate world of Bangladesh. Workers share some concerns, but generally have a more favorable view of corporate responsibility. The companies rate themselves low regarding the status of corporate responsibility practiced; with only 46.7 percent applying corporate policies to all of their operations. However, Civil Society representatives have a much more negative opinion about corporates in the country. Only 17.2 percent have acknowledged positive corporate responsibility practices. While 62.2 percent of the companies claim that they uphold the principles of human rights, only 16.7 percent of the representatives of the Civil Society appreciate the good performance of the companies in that area.

The views of business and Civil Society about corporate support for community projects are almost convergent, with 37.8 percent of companies claiming that they support such projects and 30 percent of Civil Society respondents having the same opinion. Companies are realistic regarding consultation with local communities, with 75.6 percent of the companies admitting that they have little consultation with local communities, while only 6.7 percent of Civil Society members think that the companies consult with local communities during project implementation.

Regarding child labor issues, both company executives and workers (83.3 percent and 81.8 percent respectively) indicate that child labor is not present in the companies, but civil-society groups have a different take on this issue, with only 13.3 percent of them agreeing that there is no child labor in the companies. Regarding the practice of overtime, Civil Society is again at odds with companies and workers, with only 71.1 percent of companies and 63.1 percent of workers stating that overtime is used in most of the companies, while 93.3 percent of Civil Society members think that overtime is a common practice. However, regarding minimum wage issues, the Civil Society groups and workers virtually converge in their opinions, with only 33.3 of the Civil Society members and 42.2 percent of workers agreeing that companies are paying minimum wages. The majority of the companies (81.1 percent) claim that they pay a »living wage« to their employees, which is not necessarily as high as the minimum wage.

Concerning environmental issues, interestingly, 45.3 percent of employees rate their company's environmental management systems high, compared with only 35.6% of company representatives. This might be due to the poor exchange of information on the issue, or limited employee knowledge of the topic. On the other hand, Civil Society is very negative about the environmental issue, with only 16.7 of them commenting positively about the responsible behavior of companies towards environmental protection. Regarding violation of environmental regulations, none of the employees think that companies are in violation, while 8.9 percent of the companies acknowledge this. Civil Society consistently presents negative attitudes, with 83.3 percent charging that companies regularly violate environmental regulations.

In health and safety issues, companies and workers also diverge in their opinions. About 44 percent of companies claim that they maintain health and safety standards, while the majority (71.1 percent) of employees indicated that there were violations of health and safety standards by their companies.

Source: Raihan (2003)

In this respect, there is a vital difference between domestic producers and companies with foreign involvement: The later tend to offer social and safety standards which are relatively high in Bangladesh. However, a number of the foreign firms do not fully comply with environmental and other standards which they are obliged to follow in their countries of origin.

According to the aforesaid study of FICCI, foreign investors operating in Bangladesh spend almost $12 million in CSR related activities which is however only a mere one percent of the government budget for the health and education sectors.

7.9 FDI and Poverty Alleviation

Bangladesh has gradually increased its focus on FDI as a major means for raising resources for its developmental need. However, concerns are being raised about the poverty-alleviating impact of foreign capital flow. This is particularly important given the fact that more than forty percent of the population of the country lives in poverty. The relationship between poverty alleviation and FDI inflow is complex. FDI is expected to have both direct and indirect effects on economic growth and poverty alleviation through employment creation and income generation. But precious little has been mentioned in the Interim Poverty Reduction Strategy Paper (I-PRSP) of Bangladesh regarding the anti-poverty consequences of FDI. No attempt has been made to identify parameters or yardsticks which can enhance the employment and income effect of FDI for the poor.

Bangladesh's I-PRSP reported that the rate of poverty reduction during the '90s was one percentage point per year. On the other hand, GDP growth during the 1990s was 4.8 percent in real terms per year. In other words, assuming the same type of income distribution pattern, reducing poverty by one percent per annum would require an annual growth of GDP by 4.8 percent. Bhattacharya and Deb (2004) have estimated that a ten percent increase in FDI would result in 3.71 percent increase in the GDP of Bangladesh. Thus, a one percent reduction in poverty would require an annual growth in FDI of thirteen percent. Hence, augmentation of FDI inflow remains a key task of the Bangladesh government.

The *WDR 2005* does not show a direct link between FDI and poverty alleviation, but maintains that investment climate in general is a driving force behind growth and poverty reduction. According to the report, the contribution of investment climate can be seen in two ways. »First, at the aggregate level, economic growth is closely associated with reduction in poverty. Second, investment climate improvements can enhance the lives of people directly in their capacity as workers, as entrepreneurs, as consumers and citizens, and as recipients of tax-funded services or transfers« (Chapter 1, Page 1.18).

However, it has by now become evident that increased growth is a necessary condition for poverty alleviation, but not a sufficient one. More importantly, deterioration of income distribution may continue under a high growth scenario. Bangladesh is a case in point where, despite a drop in the head-count ratio of poverty, income distribution as expressed by the Gini coefficient has become more skewed against the poor. This, incremental economic growth (spurred by FDI) may disproportionately reward the more endowed people and consequently constrain at the micro-level the access of poor people to various public goods, including tax-funded services or transfers.

7.10 Features of »Good« FDI

Obviously, intervention for pro-poor growth and fostering income equality could result in a greater impact on poverty reduction. In this context, a number of different characteristics of FDI are mentioned below which at least offer a potential for significant contributions to poverty reduction and sustainable human development:

- Joint ventures between local capital and FDI with equity participation
- Production of labor intensive manufactures
- Investment in export-oriented enterprises
- Processing of local raw materials
- Located in peri-urban areas
- Having greater forward and backward linkages

- Good record of Corporate Social Responsibility

As the *WDR 2005* does not treat foreign investment as a separate category, it has also by-passed the »quality dimension« of FDI. But in an episodic manner, it has referred to some beneficial features of FDI. For example, the report expresses its preference for foreign investment with 100 percent equity, as that may generate more interest for the foreign investor. It says that joint ventures »may deter rather than encourage investment, and can make foreign firms wary about using advanced or sensitive processes, thus reducing spillovers« (Chapter 8, Page 8.21). However, experience suggests that shared equity contributes to development of local entrepreneurship, transfer of technology and know-how, linkage with the indigenous economy etc.

SME and Privatization. The pro-poor orientation of FDI might also be enhanced if foreign investors could be motivated to invest in small and medium sized enterprises. Another interesting case would be buy-outs of state-owned enterprises by foreign investors.

Labor-Intensive FDI. Labor-intensive FDI is important, as it has a direct impact on poverty reduction through employment generation. For example, textiles and clothing, and garments require large numbers of semi-skilled and unskilled workers. . In the ready-made garments sector in Bangladesh, more than two-thirds of employees are women. Thus, we can see that the labor-intensive production process is creating both employment and income generation opportunities, and also empowering women by providing them access to cash income, more freedom in personal decision-making, including reproductive health, and the ability to forge supportive networks and fight for better working conditions.

Empirical studies have also shown that expenditure pattern of woman wage earners in Bangladesh have more poverty-reducing impact than does that of their male counterparts. It may be noted here that such FDI has low entry barriers, and allows for flexible working patterns through subcontracting arrangements and household work.

Policymakers in Bangladesh are aware of the potential problems of adverse working conditions, low wages and child labor. Bangladesh has not only successfully eliminated child labor from the ready-made garments industry, but also successfully rehabilitated the working children in a sustainable manner. While such investments can be important in FDI strategies cognizant of poverty reduction objectives, governments must also properly regulate them without chasing them away.

It is also recognized that both market expansion seeking and efficiency seeking FDI may be labor intensive. The apparel industry is a case in point. The overwhelming share of FDI in Bangladesh is in this sector.

FDI in Infrastructural Development. As mentioned above, infrastructural backwardness imposes heavy costs on private investors in Bangladesh. Better infrastructure could address basic human needs: provide access to markets, e.g. by offering reliable transport facilities or telecommunications; and improve employment opportunities. FDI in physical infrastructure simultaneously can improve the efficiency and reduce the cost of utility service provision. More importantly, it tends to free scarce public resources for other socially desirable investments.

As part of its opening policy, Bangladesh has been actively encouraging FDI in the development of infrastructure. Recent advances in public-private partnerships (PPPs) have also increased the scope of infrastructure-related investment in Bangladesh. Bangladesh has utilized FDI in power generation and natural gas exploration. However, some caution is also required in certain areas of FDI in infrastructure. It is an imperative to create a social safety net, and in some cases provide subsidies to the most vulnerable groups in society to protect them against potentially negative impacts such as higher prices for services. The government must guard against over-exposure to contingent liabilities.

Bangladesh has made significant use of FDI in infrastructural development through the build-operate-own and build-operate-transfer approaches. FDI in Bangladesh has actively participated in production of electricity as independent power producers. Foreign investment has already been involved in the construction of some bridges. International oil companies are very active in drilling and piping natural gas in Bangladesh. All these activities have improved the supply conditions of infrastructural facilities for the citizens, especially concerning the provision of power.

FDI for investment in rural areas and peri-urban areas. A number of textiles and clothing enterprises operating under foreign control in EPZs are »spatially-dispersed investments.« In the past, they have also had limited success in generating linkages to the surrounding economy, and in delivering the benefits of technology transfer through training, education and so on. While there still remain some differential fiscal benefits for enterprises in the less developed area, these tax breaks are totally inadequate to neutralize the disincentives created by the lack of physical infrastructure.

7.11 Conclusion

To attract FDI, Bangladesh has to reinforce its infrastructure facilities and improve the quality of its services. Furthermore, a consistent incentive packages should be implemented which may include fiscal measures (such as rationalization of para tariffs, elimination of non-tariff barriers), financial measures (such as reducing interest rates, access to financing) and institutional measures (such as enhancement of competitiveness through capacity building). It is true that FDI follows domestic investment, and if the level of domestic investment is low, it will not help FDI to rise at the desired level. Thus, to boost foreign investors' confidence and encourage them to investment in Bangladesh, the domestic investment rate, which is closely related to improvement of the business environment and of economic governance, should be increased.

To cope with the changing state of affairs of today's globalized world, an LDC like Bangladesh needs to develop and facilitate its negotiating capacity in the multilateral arena, to protect its own interests. The Uruguay Round of the WTO negotiations addressed some crucial issues in the agreements on TRIMS, TRIPS and GATS. To harmonize investment rules in general, the EU and other developed countries are pushing a multilateral investment agreement to give rights to foreign companies to operate in WTO member countries with national treatment status and with no restrictions on share of equity. But in developing countries, there are strong arguments against unlimited FDI and equal treatment with domestic producers, such as loss of control over quality and quantity of foreign investment, threat of a deepening BOP crisis, suspension of domestic support policy to the weak and priority sectors, reduced possibility of technology transfer etc. Compared to the present proposals and suggestions of industrialized countries and international organizations, the investment regime under GATS Mode 3 gave increased flexibility for developing countries to minimize the adverse impacts of a full opening of their investment regimes.

Thankfully, after the Asian financial crisis, the IMF is no more pushing aggressively the capital account convertibility as an instrument for attracting FDI.

Bangladesh needs to look at investment opportunities within the region. Incremental regional investment complemented by the initiative to build a regional free trade area may work as a catalyst for attracting extra-regional FDI. In fact, FDI may emerge as an integrating force in South Asia.

Simply providing incentive packages and liberalization measures will not attract FDI, nor has FDI always proved to have a positive impact on the economic growth of a country. To ensure that it does, it is necessary that governments retain the right to choose the types and directions of FDI according to their own needs. Last but not the least, good governance is crucial to ensuring the increased flow of FDI and thereby sustaining pro-poor economic growth.

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8. Brazil's Experiences with Foreign Direct Investment

Fernando Cardim de Carvalho with research assistance by Manoel Carlos de Castro Pires

8.1 Introduction

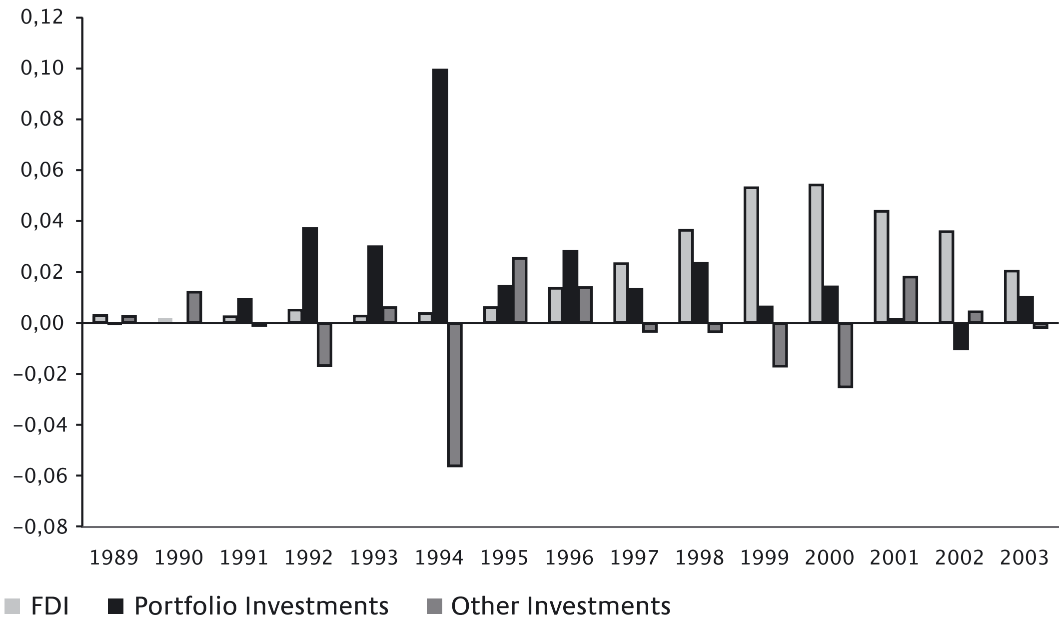
The 1990s witnessed a sharp change in attitude in relation to FDI. Foreign direct investment had traditionally been seen as a potential Trojan horse by host economies, including industrial economies in Western Europe and Asia. The main feature of FDI was seen as the transfer of control over productive resources from nationals to foreigners. It was feared that countries that welcomed FDI would lose the power to set their own strategic priorities, if they allowed foreign investors to control the use of their productive capacity, particularly in the case of foreign investment in sensitive sectors such as energy, production of some raw materials, high technology and military production. It was (and in fact to a large extent still is) widely believed that each country's productive capacity should be largely kept under control of its own citizens, at least in the case of strategic sectors. If external capital were needed to speed up economic growth, it should be accessed as credit, not as FDI. Loans could be obtained and returned according to a preset schedule, without compromising the long-term use of productive capacity and natural resources. Credit does not entail any permanent relationship between the source of capital and the host country, as FDI does.

This attitude has changed in recent years. To some extent it has been realized that national control per se may not be a sufficient condition to enable a country to promote a strategically coherent use of its resources. On the other hand, particularly in the case of developing countries, the long cycle of debt crises, beginning with the bankruptcy of Mexico, Argentina and Brazil in the early 1980s and extending crises in East Asia, Russia and again Latin America to the late 1990s, showed that external credit is not devoid of risks. The experiments with bank-syndicated credit in the 1970s and 1980s, or with bonds and other securities in the 1990s, all ended up exposing developing countries (and sometimes even developed countries as well) to sources of instability that proved to be very expensive for the countries involved.

As a consequence, the costs and benefits of FDI were reassessed in a much more favorable light. Concerns with national control became old-fashioned in times of globalization rhetoric. The belief that FDI flows are more stable than credit flows (which however is not necessarily or entirely true, as Claessens et al. [1995] show) became a strong argument for its acceptance. FDI would also complement domestic savings, usually believed to be low in developing countries. Finally, it is generally argued that FDI promotes technological progress, expands integration in international trade and speeds up growth in these economies. In many cases, it was expected that FDI could even improve both social conditions, by modernizing labor relations, and corporate and public governance, by bringing to the host country better management methods and by being better able to stare down local corrupt public administrators.

In the 1990s, Brazil became one of the main recipients of FDI among developing economies. As a matter of fact, FDI had been an important component of domestic investment for decades. It was particularly important in the growth cycles of the late 1950s, when industrialization accelerated strongly, and in the late 1960s and early 1970s, when the country's economy grew at exceedingly high rates. In the 1990s, however, the volume of FDI directed to-

Fig 8.1: FDI, Portfolio and other Investments – % GDP



ward the country was a large multiple of what had previously been received. The volume of investment has since fallen, but still remains at a much higher level than it had been. Growth, however, has been elusive, suggesting that, at least in the case of Brazil, a less naïve approach to the role of FDI should be developed.

8.2 FDI in Brazil: A General Report Overview of Current FDI Stocks and Flows

Balancing External Payments. From the balance of payments point of view, FDI has become, in the 1990s, an increasingly important element enabling Brazil to cover its external obligations. In particular, when trade surpluses gave way to trade deficits after the Real Plan, in July 1994, the country had to face a sharply unbalanced current account (transactions with commodities trade plus trade in services). The services account is always in deficit in Latin American emerging economies, among other things because it includes interest payments on the external debt. If the deficit in services trade cannot be paid for with net exports (that is, exports minus imports of goods), the country has to appeal to the external capital markets to do it (or, if this is not possible, to face the dilemma between defaulting or appealing to the IMF, both of which brings terrible consequences).[40]

Evolution of FDI and other investment flows. During the first four years that followed the Real Plan (from 1994 to 1998), Brazilian policy-makers seemed unconcerned with the increasing trade deficit, arguing that developing countries need to absorb foreign savings to accelerate growth. For the reasons presented in the introduction to this chapter, FDI has generally been seen as the best vehicle for foreign savings. However, given the excess liquidity available in the international financial markets until the Russian crisis, it was portfolio capital that was actually attracted, as one can see from Figure 1, even though FDI did increase significantly at the time (other investments relate mostly to loans made by foreigners to residents).

[40] FDI inflows, however, are not a »free lunch« from a balance-of-payments point of view. Current inflows create the possibility of future outflows of profits, royalties and other expenses, besides the risk of repatriation. Therefore, attracting FDI cannot be the final answer to balance-of-payments deficits. In the long term, the Asian experience has shown that a country must to be able to »grow out« of its balance of payments problems by increasing net exports, instead of accumulating external debt or other kinds of liabilities, like those associated with FDI. This goal can be pursued by a combination of stimuli to exports, import-substitution policies and the adoption of specific external trade surplus targets for foreign companies.

Table 8.1. Selected Accounts from Brazil's Balance of Payments

million US$										
Account		1994	1995	1996	1997	1998	1999	2000	2001	2002
Current account	-1811	-18384	-23502	-30452	-33416	-25335	-24225	-23215	-7637	4016
Trade balance	10466	-3466	-5599	-6753	-6575	-1199	-698	2650	13121	24891
Capital account	8692	29095	33968	25800	29702	17319	19326	27052	8004	5104
Net FDI		2150	4405	10792	18993	28856	28576	32779	22457	16590

Source: Central Bank of Brazil, www.bcb.gov.br/?SERIEBALPAG

After the currency crisis of 1998, portfolio investments were drastically reduced and FDI grew very quickly to become the most important positive element in balancing Brazil's current accounts deficits. The apex of FDI was reached in 2000, after which it began to decrease, a trend which is still continuing, as can be seen in Table 1, below:

Profit Remittances and Interest Payments. As data from balance-of-payments figures published by the Central Bank of Brazil (Figure 2) show, a comparison between types of external payments generated by FDI flows, i.e., those related to interest on debt, and those involving profits on foreign investments, seems to validate the expectation that the latter involve lower sacrifices for the host country, although the situation has deteriorated in recent years, most markedly since 2000. The interest bill has been higher than profit remittance for the whole period since 1989, for most of the time sharply so (note that negative numbers mean that the data refer to outflows).

In the 1990s, the renewed interest in the behavior of FDI led the Central Bank of Brazil to perform a periodical census of FDI. The data generated are not directly comparable to balance of payments flows presented above, since they are based on different kinds of records, which may diverge when the periods under investigation are as short as one calendar year.

Long-term evolution of FDI. Table 2 shows the long-term evolution of foreign direct investment flows registered at the Central Bank (registration is required for remission of profits and other payments to headquarters). Al-

Fig 8.2: Profits distribution and interest payments – %GDP

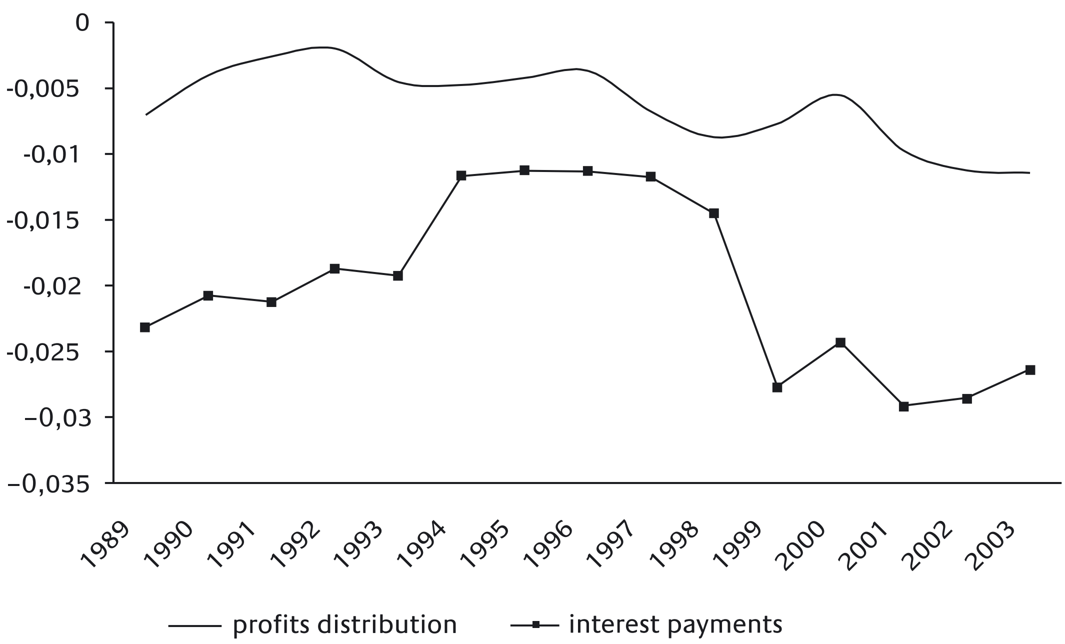


Table 8.2: FDI—Evolution in Millions Dollars of 1985

Years	FDI	Years	FDI
1951-60	956	1987	2,363
1961-70	2,127	1988	5,121
1971-79	12,353	1989	2,213
1980	1,973	1990	1,596
1981	2,483	1991	2,573
1982	2,170	1992	4,189
1983	1,656	1993	11,728
1984	1,208	1994	13,157
1985	426	1995	-3,044
1980-85	10,279	1990-95	30,201
Total	**25,664**	**Total**	**39,900**

Source: Central Bank of Brazil, Census of Foreign Investment (www.bcb.gov.br)

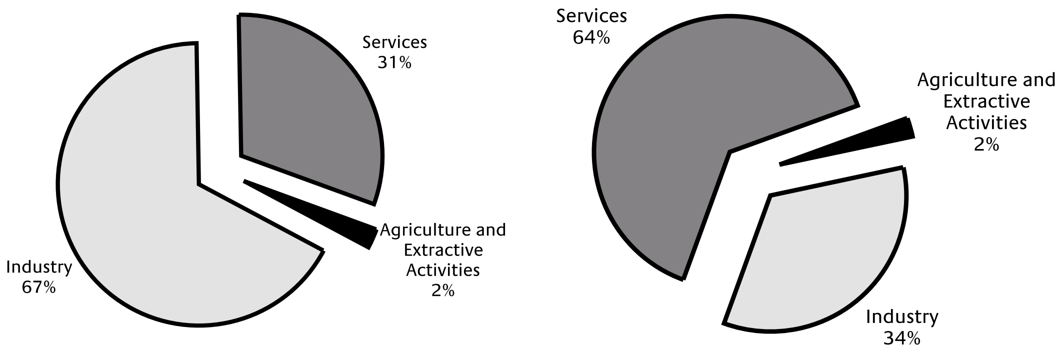
though the series ends in 1995, one can see the recent acceleration of FDI with respect to its previous level (the data are presented in 1985 US dollars, to preserve comparability).

Sectoral distribution of FDI. As it will be discussed below, FDI in Brazil has traditionally consisted mostly of investment in the manufacturing sector. However, in the late 1990s, because of the intensification of the privatization process on the one hand and the banking crisis of 1995-'96 on the other, the service sector, too became a privileged target for FDI. Figure 3 shows how the allocation of FDI stock changed between 1995, when it was closer to the traditional pattern of distribution, and 2000.

Countries of origin. The same process was reflected in the ranking of investment according to the countries of origin of FDI, shown in Table 3. In 1995, the ranking of countries corresponded to the expected pattern, dominated by the richest countries. In 2000, some striking changes took place: firstly, the amazing increase in participation of tax havens, such as Bermuda, the Channel is./Man, the Cayman Islands and Luxembourg; secondly, the increase in the participation of lower-income industrial countries, such as Spain and Portugal, which concentrated their investments in telecommunications and banking, taking advantage precisely of the privatization process and the banking crisis mentioned before. Spain

Fig 8.3: FDI Stock for Economic Activity—1995

FDI Stock for Economic Activity — 1995 | FDI Stock for Economic Activity — 2000



actually became the second largest investor in Brazil by the end of the past decade.

Annex 1, at the end of this chapter, lists the foreign companies that were among the 100 largest non-financial firms in Brazil, measured by total revenue, in 2002. The list was compiled from an annual survey of Brazil's largest firms prepared by the business daily *Valor Economico.* Again, it should not be compared directly to the data in this section, which is based on the Central Bank's records. Notable is the heavy concentration of foreign companies in some sectors, such as vehicles and parts, and telecommunications, as well as the attempt to penetrate sectors like power supply, where, however, their participation is limited to distribution. Foreign companies are actually present in a large number of sectors, but, as shown in Figure 3, agriculture and mineral extraction activities are not among them, a notable feature the consequences of which will be addressed below. It is perhaps the pattern of allocation of FDI, rather than the absolute amount per se, that distinguishes the activities and impacts of FDI in middle-income and less developed economies.

8.3 FDI during the Period of Import Substitution (until the 1980s)

Remote beginnings. Foreign direct investment has been no stranger to the Brazilian economy at least since the beginning of the twentieth century. As a former colony of Portugal, foreign interests have always been strongly present in the local economy, in particularly of those countries which dominated Portugal itself, first the Netherlands, later Great Britain.

After independence from Portugal in 1822, ties with Great Britain remained strong. In the second half of the nineteenth century, British capital built and operated a railway system, which was essential for the exports of coffee that were the main economic activity of the country until the 1930s. It should be noted, however, that the main productive sector, agriculture, was owned and controlled by nationals; foreign-owned plantations were never a major factor in the country. Foreign capital was concentrated at first in commercial and financial activities, and in public utilities and infrastructure, such as railway transportation and power generation.

FDI and import-substitution industrialization. Industrialization did not change this picture much in its early stages. Import-substi-

Table 8.3: FDI Total Stock—Country Distribution (Million Dollars 1995 values)

1995 Census		2000 Census			
Canada	1,818	Bermuda	1,940	Panama	1,580
France	2,031	Channel is./Man	3,196	Portugal	4,512
Germany	5,828	Canada	2,028	Spain	12,253
Italy	1,258	Cayman Islands	6,224	Sweden	1,578
Japan	2,658	France	6,930	Switzerland	2,252
Netherlands	1,545	Germany	5,110	Great Britain	1,487
Switzerland	2,815	Italy	2,507	United States	24,500
United Kingdom	1,862	Japan	2,468	Uruguay	2,106
United States	10,852	Luxembourg	1,034	Others	10,021
Others	11,024	Netherlands	11,055		

Source: Central Bank of Brazil, Census of Foreign Investment.

tution industrialization was stimulated during periods of rupture in international economic relations, such as the two world wars and the Great Depression of the 1930s. Opportunities in these periods emerged mostly in light industries, such as non-durable consumption goods, and were taken up mostly by local entrepreneurs.

The 1950s were the period where the most dramatic changes in the Brazilian productive structure, and in the role of foreign investment, took place. Industrialization became, in those years, an explicit goal rather than just a result of exogenous changes in current economic conditions. In the first half of the 1950s, the industrialization push exhibited a more nationalistic face, led by state initiatives such as the creation of the National Development Bank (BNDE), Petrobras (the oil company owned by the federal government, endowed with monopoly powers to operate in the sector) and Eletrobras (electric power company, also owned by the federal government). During World War II, the federal government had already created a steel company, CSN. All of these companies were to perform an important role in the process of economic development of Brazil.

Pushing industrialization forward in the late 1950s. In the second half of the 1950s, the government led by President Juscelino Kubitschek (1955/1961), decided to accelerate growth, promoting a concerted industrialization effort known as the Targets Plan (Plano de Metas), summarized by the slogan »50 years in 5.« This time, in contrast to the first half of the decade, foreign direct investment would be essential to reach the rapid results sought by the government. The state would still perform a strategic role, both as a coordinator and as investor. As an investor, the state mostly confined its initiatives to building roads and other public physical infrastructure, besides building the new federal capital, Brasilia. To have the economy grow at the desired rates, a massive inflow of foreign capital was promoted.

Transportation was a key element of the Targets Plan. The state was to build roads, and foreign firms would produce the vehicles. Although American companies, such as Ford, had had a long-established presence in Brazil, they did not seem interested in transferring productive facilities to the country. In fact, in the 1950s, US companies were mostly interested in contesting European markets, newly recreated through reconstruction efforts in the immediate post-war period. The pressure from American companies to gain market shares in Europe forced European companies to look for other national markets which they could occupy, in a defensive move to strengthen their competitive position in the face of the American threat. The creation of an automobile sector in Brazil was, thus, the result of the coincidence of an effort by the Brazilian government to attract investment at the same time that European companies were searching for new markets to strike roots in (a similar coincidence would occur in the banking sector in the late 1990s). As a result, a heavy flow of European investment was directed towards Brazil during this period, particularly from German corporations such as Volkswagen and Daimler Benz.

Legislation with respect to FDI. To promote the increase in FDI flows, local regulations and legislation related to capital flows had to be changed. Some import regulations were amended, to allow investment in the form of capital goods instead of monetary flows. Furthermore, some privileges in the form of fiscal benefits were offered, although only on a temporary basis. Most important of all, however, was the perceived necessity to regulate the rights and duties of foreign investors, which was fulfilled, amid much political controversy, with Law 4131, passed by Congress shortly before the military coup of 1964. This law has been amended a few times, but its basic provisions still hold. The central dispositions relate to remittance of profits. In its original form, Law 4131 limited the amount of profits that could be repatriated. Shortly after the military coup, this limitation was changed into a graduated scheme according to which profit remittances would be subjected to a progressive tax scheme when they represented more than 12% of a company's capital. In addition, expenses that could serve as conduits for hidden profit remittances, such as payments for royalties or loans granted by headquarters to the subsidiary, were also subjected to special taxation.

Law 4131 still sets the basic framework for FDI acceptance in Brazil. Although it was originally conceived largely as an administrative instruments limiting the action of foreign firms, it was quickly transformed into a market-friendly piece of regulation with foreign firms facing disincentives, but not necessarily prohibitions, against sending money abroad, as profits or otherwise.

8.4 FDI during the Lost Decade (the 1980s)

When the Targets Plan ended in late 1960, the economy began to cool down. A parallel political crisis eventually led to the military coup of 1964. Naturally, this environment was not attractive to FDI, which resumed only after the economy recovered in 1967-'68, when the period known as the Brazilian Miracle began. From 1968 to 1973, the Brazilian economy grew at a very high rate, over 10% in real terms in the last years of the boom. A new cycle of investments took place, focusing mostly on the production of consumer durables. The two oil shocks of the 1970s again interrupted Brazil's growth. Reacting against the external shocks of that decade, the federal government launched an ambitious import-substitution and export-promotion investment plan, involving both public and private resources, domestic as well as foreign. The Plan (known as II PND, or National Plan of Development) was destined to become the swan song of industrial policy in Brazil, at least until the election of President Lula da Silva, when it was rehabilitated as an instrument of government.

Economic crises in the 1980s. The 1980s were marked by political re-democratization on the one hand, and deep economic instability on the other. The decade began with the balance-of-payments crisis of Mexico, Argentina and Brazil, and continued, in the cases of Argentina and Brazil, to generate semi-hyperinflationary processes that all but paralyzed these economies. The danger of economic instability leading to a deep political crisis was known to be very serious: the population was led to believe that re-democratization was synonymous with resumption of growth simultaneously with income re-distribution. A disappointment of expectations related to the economy could easily turn into a disappointment with democracy itself.

Under civilian rule, which culminated in the federal constitution promulgated in 1988, new laws and regulations were created which established some forms of discrimination against foreign firms by differentiating between Brazilian firms owned by Brazilians and Brazilian firms owned by foreign interests. This discrimination was badly received, not only by foreign investors themselves but also by neo-liberal politicians and economists who became increasingly vocal in the late 1980s. In fact, amid signs of rapid economic deterioration in 1989, neo-liberal groups became hegemonic by winning the presidential election in that year. President Collor de Mello was ultimately forced to resign to avoid impeachment proceedings for corruption, but his neo-liberal views prevailed and were maintained even by the nominally center-left Cardoso administration—and to date also by the Lula administration, albeit with some reservations.

Neo-liberalism in the 1990s. The rise of liberalism in the 1990s led the government to propose and obtain the elimination of the discrimination between domestic and foreign private companies. One must keep in mind, however, that this meant ending discrimination against foreign investment by giving them the same privileges, not more, given to domestic firms.

8.5 FDI in the Phase of Exchange-Rate Based Stabilization (the 1990s)

The Brazilian economy became attractive to FDI again only in the second half of the 1990s, after price stabilization was achieved through the Real Plan (named after the new currency, the real, which was then introduced), in 1994. The stabilization strategy embodied in the plan was very risky, from the macroeconomic point of view, and ultimately led, in fact, to a currency crisis in 1998. Nevertheless, the Real Plan was very efficient from the point of view of rapidly reducing inflation to manageable levels. The strategy was to have deeply important implications for the behavior of FDI in the economy.

Trade liberalization and FDI opportunities. One of the central tenets of the stabilization plan was to combat domestic inflation with imports, which were made particularly cheap by a combination of trade liberalization and overvaluation of the domestic currency. The strong competition of imported goods led many domestic firms to the brink of bankruptcy or to downright failure. This created many opportunities for foreign interests to acquire local companies at exceptionally low prices. One should note that many of these firms were failing not necessarily because they were inefficient or unable to compete, but because they were unable to compete in an environment defined by the overvaluation of the domestic currency.[41] In other words, the opportunities for mergers and acquisitions by foreign investors interested in domestic companies were very attractive and led to a sharp rise in FDI in the second half of the 1990s. Thus, a large portion of this FDI was not green field investment that would have increased productive capacity, but rather merely the counterpart to domestic disinvestment.

Privatization and FDI. Another important opportunity for FDI was created by the process of privatization of state-owned companies. Privatization had already become a policy objective during the 1980s. However, it was only with the triumph of the neo-liberal ideology that it was implemented on a large scale. The political instability of the Collor de Mello period did not allow many initiatives in this area, but the Cardoso administration pushed privatization forward strongly.

The motivation behind the privatization process in the Cardoso period seems to have been fiscal in nature, even more than political. A growing public debt (resulting from the attempt to sterilize inflows of portfolio capital) increasingly threatened the solvency of the public sector. Hence, the Cardoso administration saw in the sale of state-owned firms a source of potential revenues to offset the growth of the government's liabilities. For this reason, the model adopted was to sell the companies to an individual controller or an organized group of controllers (as opposed to, for instance, selling shares to the general public). Privatization, however, at least of some of the most important companies, usually in the context of strong political symbolism, proved to be a more complicated political operation than expected, particularly when prospective buyers were strong local interests or, even more dramatically, foreign groups. Specific sales were challenged by a large number of lawsuits. Street demonstrations on the days of the auctions frequently ended in violence.

Financing privatization. Concerned with the possibility of failure in these auctions, which would compound the political losses already involved in the privatization program, the federal government got actively involved in the attempt to find buyers for the companies. In some cases, cheap financing was offered through the National Development Bank (now BNDES). In other cases, pension funds would be pressured into joining consortia of buyers to guarantee the funds necessary for the acquisition.

Under these conditions, privatization ended up being another great opportunity for foreign companies. In many cases, firms were acquired with money borrowed locally at exceedingly favorable terms. To make sure of sparking the interest of foreign investors, very enticing pricing clauses for the services to be provided by the new company were drafted, sometimes including provisions that later proved very problematic, such as the indexation of prices to US dollars.

As in the case of M&A operations, FDI related to the privatization of state-owned companies did not lead to any increase in productive capacity. In many cases, the buyers implemented downsizing measures immediately after acquisition.

FDI and economic growth in the 1990s. Since very little of the large volume of FDI in the late 1990s was greenfield investment, it is hardly surprising how small its impact on the overall economy has actually been. Aggregate investment has not increased during the period (as one would expect, since FDI was the result of disinvestments by the public sector and by the private domestic sector). As for the economy as a whole, it simply continued on its cycle

[41] Overvaluation always implies an economy-wide loss of international competitiveness, penalizing domestic production. Hence, overvaluation, if maintained for long periods of time, inevitably leads to trade deficits, local bankruptcies and increasing unemployment.

of stagnation that has been unfolding since the early 1980s.

FDI and industrial policy. Finally, the rise of the neo-liberal view had another significant implication for FDI. During the long tenure of President Cardoso (1995 to 2002), the term »industrial policy« was demonized. Cardoso himself, a former left-wing sociologist, argued that globalization had made this such policies obsolete. His team of neo-liberal economists would argue, by contrast, that industrial policy was just another instrument typical of the crony capitalism practiced in the past, during the import-substitution period, the eradication of which it was their mission to achieve. Thus, the surge of FDI in the late 1990s took place in an entirely different environment than that of the 1950s or even the 1970s. In the 1950s, FDI was welcomed as an element of a general economic plan. In the 1970s, FDI was welcomed in an environment defined by strong centralization of political power, including on economic matters, in the hands of the military rulers. In the 1990s, it was for the »markets« to decide what FDI should do.

With the election of Lula in 2002, industrial policies came back into favor, even if, so far, little has been actually put in place. In fact, the government has announced ambitious long-term goals. The strategy documents, however, are entirely silent about FDI. Sectoral priorities have been established, vulnerabilities have been identified for further exploration of possible precautions, but no mention whatsoever has been made about the role, if any, to be performed by FDI. Even when dealing with balance-of-payments problems and external sources of vulnerability, the government's strategy has been limited to stimulating net exports. A widespread, but still too diffuse, view that the role of foreign capital in the process of development, whatever its nature, should be limited, may be the explanation for this apparent oversight.

8.6 Evaluating the Brazilian Experience

FDI and domestic markets. The most important feature of the Brazilian experience with FDI is that foreign companies came to the country primarily to exploit its domestic markets. In the early 1950s, the Brazilian government was engaged in pursuing industrialization through import substitution, which implied raising the degree of protection of local producers against imported goods. Despite Brazil's relatively low per capita income, the absolute size of the population plus the fact that income concentration created a large number of potential consumers for sophisticated goods, induced foreign firms to build local productive facilities. Thus, concentration in the manufacturing sector and an orientation toward domestic (and, later, with Mercosul, regional) demand were the primary characteristics of FDI in Brazil. Foreign investment was initially made under conditions specified by the government, setting minimum levels of local content and reserving some sectors (particularly those supplying components to foreign companies) to domestic firms.

It is also important to note that the initial FDI inflows of modern times, in the 1950s and early 1960s, took place in an environment characterized by a strong influence of nationalistic and progressive political movements, sometimes embodied in political parties, sometimes led by the government itself. In addition, an extensive code of labor legislation had been adopted in the late 1940s, which had also created a network of powerful trade unions, albeit mostly subordinated to obscure political formations. The investment climate, as it came to be conceived by multilateral financial institutions much later, was definitely far from ideal, which didn't prevent foreign companies from coming in to take advantage of the opportunities for profit-making that rising domestic demand was creating.

The current legal framework. Brazilian laws and regulations currently discriminate neither in favor nor against FDI per se. The federal government cannot offer any subsidy or special favor to foreign investment that it would not also extend to domestically-owned companies. However, it cannot punish firms for being owned by foreigners either, except in a few exceptional cases where sectoral regulations bar foreign firms from participation. In some of these cases, in fact, it is not foreign investment per se that is banned, but private investment in general (for example, in electric power generation or, until the 1990s, oil extraction). In other cases, the restrictions do apply to foreign investment, but according to practices generally accepted or established by treaties, as is the case with the prohibition of foreign airlines from engaging in domestic air transportation. Finally, there are restrictions that are specifically applied to foreign firms due to legislation adopted in the past, which, even when currently contested, still remains in force. In the Brazilian case, this is most evident in the banking sector, where entry of foreign banks is controlled and decided on a case-by-case basis. It is worth noting, however, that most of the cases in which foreign investors are subject to discriminatory regulations are being disputed by developed countries in current trade negotiations, such as at the FTAA or the WTO (included in the so-called Singapore Issues).

FDI and international trade objectives. Although it is expected that foreign companies will actively promote exports, there is no particular contractual engagement to this end, nor are there any performance criteria defined in terms of trade objectives. A typical case is the automobile industry. Firms like Fiat or Volkswagen are active exporters, but are also large suppliers to the domestic (and regional) market. Export processing zones used to be a recurrent theme of debate, but except for the Zona Franca de Manaus (duty free zone in Manaus City in the Amazon region, where there are very few opportunities for economic activities), this kind of initiative has never prospered. In particular, the Mexican maquila model has never been considered a serious alternative in Brazil.

To some extent, the mere presence of foreign companies in the economy should be enough to stimulate exports, since most international trade nowadays is intra-corporate. This is in fact one of the strongest arguments in emerging economies for liberalizing entry rules for FDI. It is argued that trade is mostly performed by multinational firms that organize their internal division of labor globally. So if a country sets itself the goal of increasing exports on a significant scale, it should be prepared to receive FDI in large amounts and, in fact, should actually offer special facilities for foreign companies to consider investing in the country, even if that were to mean reduced tax revenues, or offering financing on favorable terms. Of course, to some extent the argument is fallacious, since the goal is to increase net exports (for instance, to earn surplus revenues to service the external debt). To increase FDI inflows means supplying other plants of the same transnational enterprise, but of course also being supplied by those other plants. From a balance-of-payments point of view, attracting FDI does not necessarily mean a stronger external position, but merely a more active one, in terms of trade.

Fiscal wars between states. During the Cardoso administration, industrial policies were banned, and the allocation of resources among investment projects became a responsibility of markets. Some barriers to the penetration of FDIs were dismantled (as in the case of the oil sector), others were maintained, at least in part (as in the case of the banking sector). A new element emerged however: the states of the Brazilian federation began engaging in fiscal wars with one another, competing for investments by offering tax credits for specific projects. Again, this competition did not discriminate explicitly in favor of FDI, although some of the investment projects with the highest profiles were in fact by foreign companies.

Reviving industrial policies. With the Lula administration, industrial policies has come back into favor, but the official documents defining the policies make no mention at all of FDI. Even from the point of view of balance-of-payments stability, the emphasis is on strengthening reserves of foreign currencies through increased net exports. In general, the view that economic growth cannot depend on foreign resources no matter what their form may be seems to prevail, but no specific strategy has been formulated to reduce the current importance of foreign investment in the Brazilian economy.

Labor standards and social policies. Foreign companies have not been associated with the debasement of labor standards in Brazil. In fact, in general, it has been the opposite. Foreign firms seem to be more comfortable with more modern labor relations than domestic firms, even in dealing with industrial conflicts during wage negotiations with unions, for instance. It is generally pointed out that modern practices of trade unionism were born precisely in areas and sectors dominated by foreign firms. In particular, the Workers Party and Lula himself have their roots in the »ABC area«, in metropolitan São Paulo, where the foreign automobile companies have settled. It is generally thought that foreign companies maintain higher standards of labor relations than domestic one do. This behavior is probably explainable, at least in part, by the fact that most of the foreign corporations in Brazil have been in manufacturing industries, and came to the country during the 1950s, when urban workers were organized in trade unions. Besides the already mentioned nationalistic feelings prevalent during that decade, a relatively free political environment also favored a more balanced relationship between workers and foreign companies, and some minimum standards set at that time survived even after the authoritarian governments that followed the 1964 military coup, which actively suppressed the labor movement during the late 1960s and during the 1970s. Another factor influencing the behavior of foreign companies related to labor practices and social attitudes was their mode of penetration of the local economy.

FDI and local market demands. Focused on domestic urban markets as most of the foreign companies operating in Brazil were, and with a particularly strong presence in the production of consumption durables, they have tended, not least for marketing reasons, to be concerned with their public reputation and with the preservation of the goodwill of the general public. This has strengthened their trademarks and their position in the domestic market. For this reason, a certain number of companies seek to offer patronage to cultural activities or to social projects in general, again to a larger degree than most domestic companies (those state companies that have escaped privatization tend to do the same, and for very much the same reason: public goodwill).

The situation may have changed somewhat during the 1990s, and may change even further. In some cases the impact of FDI in privatization has definitely been positive, as in the telecommunications sector. In the recent past, when the sector was still controlled by state-owned enterprises, telephones were so difficult to obtain that they were considered an asset (taxpayers had to include them in the section on assets and liabilities position in their annual income statements). Since privatization, foreign companies have flooded the market with cheap cell phones, turning that into a mass market. The privatization process in tele communications was designed to promote competition between the suppliers of telephone services, and it has succeeded in pushing companies to provide services to a wider share of the population. In other cases, the impact on poverty has not been as positive. In the case of public services such as electric power supply, state-owned companies were usually engaged (perhaps involuntarily) in »informal« distribution programs, where low income groups (in slums, for instance) accessed power simply by hooking clandestine lines to lamp poles. Once these firms are privatized, they tried to curb clandestine consumption, depriving these groups of services. The past pattern of »distribution« was obviously inadequate, but at least it gave low-income groups access to these services. In some countries, like Bolivia and Peru, where the same phenomenon also took place, riots were frequent until some solution could be found to preserve access. Privatization of other essential public services could reproduce the same problem in Brazil, since in these sectors service providers are usually monopolists, free from the need to build a reputation. Hence, the abolition of monopolies, by enforcing competition through (domestic or foreign) companies, tends to improve the provision of services for those groups in society who can afford to pay what is charged for these services. However, in most cases, the inadequate and poor access of socially deprived groups to these services is actually reinforced.

New patterns of FDI since the 1990s. The preceding analysis suggests that there are important causes for concern as to the future influence of foreign companies in developing economies with characteristics like those of the Brazilian economy. First, the rise of neo-liberal views underestimates the need for an industrial policy to regulate and direct FDI according to the interests of the host economy. Second, these views are strengthened by the influence of such multilateral institutions as the IMF and the

World Bank, and by the pressure of developed countries in multilateral trade negotiations, which all pursue the same goal: to liberalize markets and reduce the scope for active industrial policies. Third, FDI (and other forms of financial capital) are stimulated not as an element of a long-term development strategy, but because of a short-term need to balance external payments. Fourth, the new paradigm of industrial organization by transnational firms is to globalize their internal division of the market, so that investments are no longer made to supply local, but rather global markets, thereby reducing the incentive to build local goodwill.

The need to create new safeguards. The change in paradigms suggests that, in the near future, even such middle-income countries as Brazil may face adverse cost/benefit ratios with FDI, due to the weakening ties between foreign companies and the local economies. In any case, the most important elements to distinguish the Brazilian economy are its size and the expectations of economic growth. Despite the years of stagnation, there is still a strong bet on the future performance of Brazilian markets. On the other hand, with re-democratization after the end of military rule the influence of Civil Society organizations, new form of political activity in the country, has been much strengthened. Notions of social and ethical responsibility have spread quickly among all layers of society, including entrepreneurs. The Ethos Institute, an NGO created by a former entrepreneur and co-organizer of the World Social Forum, has a membership of 888 firms, and the mission »to spread out the practice of entrepreneurial social responsibility« which includes seeking forms of development which are »socially, economically and environmentally sustainable.«[42] Of the forty-five foreign firms listed in Annex 1 as being among the 100 largest firms in Brazil in 2002, at least twenty-three are members of Ethos.

8.7 FDI in Brazil: Issues and Perspectives

Assigning responsibilities. The Brazilian economy and Brazilian society are well-known for their deep imbalances, with extreme poverty living side by side with first world affluence. Income is extremely concentrated, by any possible criterion: functional, personal or regional. Moreover, after more than twenty-five years of rapid growth, the Brazilian economy sank into stagnation in the early 1980s from which it has yet to emerge. During the '90s, the economy solved a long-term problem, inflation, only to be caught by another equally fatal disease, external vulnerability. The Brazilian case is thus far from being an example of success to be emulated by other developing countries. However, these difficulties and imbalances could hardly be explained to any sensible degree by the influence and impact of FDI. As was argued above, the reasons for it have little to do with any form of idealization of the positive contributions some analysts expect to be made by foreign companies, but are simply due to the fact that their penetration and behavior has, in the case of Brazil, mostly been defined by local governments following well-defined strategies. The social imbalances one witnesses even with the most casual look at Brazil are basically rooted in local privileges, exploitative practices by local entrepreneurs and conservative, or just simply inept, policies by domestic governments. In countries like Brazil, poverty and inequality will be overcome by the change in their domestic social structures and reorientation of local government policies, not by the action of foreign investors, whatever this action may be. It is the Brazilian brand of capitalism that is to be blamed for its social injustices, of which FDI is an important, but hardly the most important, element.

External vulnerability. The most difficult macroeconomic problem faced by the Brazilian economy in recent years has been the vulnerability to balance-of-payments shocks (resulting from the dependence on capital inflows to cover the service of the external debt). These difficulties have been created mostly by excessive borrowing and by capital-account liberalization during the early 1990s. Capital flows play an essential role in the country's inability to grow, but FDI has not been an important cause of problems so far. Financial capital flows have been much more important, both when they come to the country and when they leave. Two provisos should be added though. First, the border between the two types of flows (FDI and financial capital) is not always clearly

[42] Cf. www.ethos.org.br.

set. In the case of foreign investment in the stock exchange, for instance, the difference between FDI and financial placements is merely a question of degree, not of nature.[43] Secondly, FDI has not been a major concern so far from a balance-of-payments point of view, because for most of the post-war period, it has represented a relatively small share of the Brazilian capital account. The last few years may have changed this picture. The huge amount of FDI that was internalized may have created liabilities for the future that may be difficult to honor in the event of a major external crisis. In other words, the Brazilian experience since World War II does not teach complacency with respect to FDI, but in fact quite the opposite: the conditions in which foreign investment was helpful were narrow, and any step towards changing them should be carefully considered.

Taxes, interest and inflation rates. Neither has FDI exerted a discernible influence on issues like taxes, interest rates and inflation rates. The tax system does not discriminate against or in favor of foreign firms. Very few decisions related to the tax system are made with FDI in mind. For a period during the 1990s, fiscal wars between states became a serious problem, but the federal government intervened to limit the possibility of states' conceding tax relief to particular projects, defusing the conflict. As to interest rates, their behavior is heavily influenced by movements of portfolio capital, but again, not by FDI. Finally, inflation is related to FDI, mainly because sectors dominated by foreign corporations tend to be organized as oligopolies. Markups over costs tend to be higher in these sectors because of their market power, as is also the case in sectors dominated by domestic oligopolies.

Contribution to technical progress. If the presence of foreign companies in Brazil has not validated the worst fears as to the damage they could cause to developing countries, neither has it confirmed the most optimistic expectations. During the 1950s, FDI contributed to increased productive capacity and promoted technical progress in the country, by making it possible to build a manufacturing sector, and by actually integrating foreign firms with local suppliers, as in the case of the automobile industry. Increasing capacity and promoting technical progress, however, is not an intrinsic characteristic of FDI, as it is witnessed by the recent experience of Brazil and of many other countries in similar circumstances. During the 1990s, FDI consisted to a large extent of buying local firms at bargain prices, and adding little if anything to local capacity.

Summing up. On balance, the Brazilian experience with FDI has been relatively benign. Except for the period of the neo-liberal experiment of the 1990s, foreign investors have been unable to impose any special terms that could be seen as grossly unfavorable to the country as a whole. Most of the damage caused during the post-war period can be traced to the action of domestic private firms, or even state companies. For instance, heavy damage was caused to the southern shoreline by oil spilling by Petrobras, the state-owned oil producer. The destruction of the rain forest in the Amazon can be largely traced to local cattle-raisers and Brazilian soybean producers.

The factors that have made the presence of FDI in Brazil largely benign may be largely exhausted, however, or at the brink of exhaustion, so that renewed attention must be given to its risks and to the need to consider its role carefully. The bottom line of the argument developed in this chapter is:

(1) Do not depend on FDI (receive it as a complement to domestic public and private capital).
(2) Frame it within a well-defined industrial policy.
(3) Have it to supply primarily the local market, avoiding export platforms and resist-

[43] In the case of Brazil, for instance, the purchase of stocks in a stock exchange is considered FDI if the share of voting rights acquired is enough to define a controlling interest in the firm. The difficulty then becomes, of course, how to set a precise distinction between a purely financial interest in the stocks of a firm and a controlling interest. On the other hand, some forms of capital circulation try to take advantage of tax or other laws that discriminate between types of flows. For instance, remittance of dividends is subject to the income tax. Payment of interest, on the other hand, is considered cost, not income, and could be exempt from the income tax. Brazilian law, recognizing the potential for misrepresentation involved in this discrimination, tries to prevent dividends from being disguised as interest payments by considering loans from headquarters to the subsidiary foreign investment, to be remunerated by dividends, instead of loans which receive interest.

ing use of long-term instruments like FDI to solve short-term balance-of-payments problems.

(4) The Asian experience shows that balance-of-payments problems should be solved through stimulating net exports, preferably by domestic companies, which can achieve more efficient economies of scale and develop better methods of production and management if they have to compete in international markets.

(5) If you do need foreign financial resources, prefer FDI to portfolio investment or to bank credit; in any case, take the necessary precautions to deal adequately with it.

(6) Finally, strengthen social organizations to keep up the political pressure on foreign firms to behave according to the interests of the society where they are striking roots.

Annex 8.1: Largest Foreign Firms Operating in Brazil by Total Revenue in 2002

Company	Country of Origin	Sector	Ranking
Volkswagen	Germany	Vehicles and Parts	4
Telefonica São Paulo	Spain	Telecommunications	7
Shell	Holland/UK	Commerce/Wholesale	8
GM	USA	Vehicles and Parts	10
Esso	USA	Commerce/Wholesale	12
Bunge Alimentos	Bermuda	Food	13
Carrefour	France	Commerce/Retail	16
Embratel	USA	Telecommunications	18
Texaco	USA	Commerce/Wholesale	20
Cargill	USA	Food	21
Fiat	Italy	Vehicles and Parts	22
Eletropaulo Metropol	USA	Electric Power	23
Nestlé Brasil	Switzerland	Food	28
IBM	USA	Computing	29
DaimlerChrysler	Germany	Vehicles and Parts	33
Gessy Lever	Holland/UK	Hygiene	35
Light	France	Electric Power	37
Ford Motor	USA	Vehicles and Parts	39
Telesp Celular	Portugal	Telecommunications	40
Nokia	Finland	Electronics	43
Bunge Fertilizantes	Bermuda	Chemicals	45
Sonae	Portugal	Commerce/retail	49
Basf	Germany	Chemicals	52
Souza Cruz	UK	Tobacco/Alcohol. bev	55
Agip	Italy	Commerce/Retail	59
Makro	Holland	Commerce/Wholesale	60
Motorola	USA	Electronics	66
Unilever Bestfoods	Holland/UK	Food	67
Bosch	Germany	Vehicles and Parts	69
Coinbra	France	Food	70
Siemens	Germany	Electronics	71
Alcoa	USA	Metal	74
Alstom	France	Electronics	75
Bompreço	Holland	Commerce/Retail	79
ABB	Switzerland/Sweden	Mechanics	83
Multibras	USA	Electronics	85
CNH	Italy	Vehicles and Parts	86
Telefonica Celular RJ	Spain	Telecommunications	87
Pirelli Pneus	Italy	Plastics/Rubber	88
Xerox	USA	Computing	89
Bandeirante Energia	Portugal	Electric Power	91
Renault	France	Vehicles and Parts	94
Seara	Bermuda	Food	97
Goodyear	USA	Plastics/Rubber	98
Peugeot/Citroen	France	Vehicles and Parts	100

Note: Pão de Açucar (wholesale commerce), CST (steel) and Belgo-Mineira (steel) were not listed because they are combinations of domestic with foreign groups (French, Japanese and Luxembourg, respectively)
Source: Valor 1000 Maiores Empresas, 2003 Edition, August 2003.

9. FDI: Regulation—A Customary Business

Martina Metzger

As outlined in the Introduction, the World Bank has, with the *World Development Report 2005* completed a task assigned it by the International Conference on Finance for Development in Monterrey in 2002. Especially the issue of how to provide sufficient funding to realize MDGs is of central importance. The *WDR 2005* focuses on private investment as a key to additional financial resources for developing countries, by means of which poverty reduction is assumed to be transformed. However, from the point of view of Civil Society, the *WDR 2005* is considerably flawed.

There are in fact statistical links between economic growth and poverty reduction, but whether there are also causal links between them, and in which direction the causality runs, is unclear. What can be stated with absolute certainty is that the trickle-down approach has been a failure. But this does not bother the World Bank today. Its assessment of private investment activities and recommendations for government officials to improve the investment climate is based on the simple assumption that companies undertaking an investment are at the same time automatically increasing societal well-being. The more companies invest, the higher the economic growth, the better for the poor, socially deprived groups and the environment—that is one of the main messages of this year's *World Development Report.* Hence, in the World Bank's world, poverty reduction and a sustainable catch-up process are mere by-products of the process of maximization of private profit.

Another general misunderstanding of the World Bank consists in its suggestion that more FDI inflows generate financial resources, which will be at the disposal of the governments of developing countries for financing MDGs. However, in the real world this is not the case; often, in fact, the contrary is the case. TNCs own the financial resources of an investment, be it in domestic or foreign currency, unless they present it as a gift to governments—which they obviously do not do. Sometimes TNCs even demand additional public financial resources, such as tax exemptions or unlimited supplies of foreign exchange, which national or local governments have to provide. The central role which international institutions like the World Bank, but also the WTO, is assigning to property rights of investors on the development agenda might serve here as an indicator that the international development business is more concerned with the protection of private property than with social property rights, biodiversity, or such human rights like the rights to life, adequate food, health care and education.

Hence, from a Civil Society point of view it is necessary to take stock of developmental risks involved with FDI and to define conditions under which foreign investment is not socially and environmentally harmful. With respect to development goals, the most damaging of all the risks identified in this Civil Society Report are: (1) increasing foreign indebtedness; (2) reduction of the national debt service capacity; (3) reduced access to financial and social services; (4) greater income concentration; (5) worsening of working conditions; and, last but not least, (6) reduced national sovereignty (see also Executive Summary and Chapter 10).

To state it positively: To have a net positive impact on the host country and especially on the achievement of MDGs, FDI would have to conform to certain criteria, including: (1) improving the external position of developing countries, which are all net foreign debtors; (2) showing a counter-cyclical effect, or at least being neutral to typical boom-and-bust-cycles induced by other financial flows like traditional credits or portfolio investment; (3) generating net employment opportunities for the domestic workforce; (4) ensuring core labor standards and social security; (5) increasing the added value by capacity-building of the domestic workforce, technical up-grading of processing procedures and enforcing forward and backward linkages, especially with SMEs; and (6) maintaining the environment intact and preserving biodiversity.

There exists the incredible number of some 2000 bilateral and regional investment treaties, accords on TRIPS and TRIMS within the WTO, and numerous voluntary codes of conduct like the Global Compact, the OECD Guidelines and the Investment Guidelines of the International Institute for Sustainable Development of the World Bank Group, not to mention investment and export guarantee schemes of industrialized countries which considerably influence investment strategies of TNCs. Hence, the question is not whether there should be regulation on FDI or not, but what kind of regulation, by whom and in whose interests.

a. *What kind of regulation?* The two key weaknesses of a code of conduct, of which the Global Compact of 2000 initiated by the United Nations and now signed by about 1400 transnational corporations is the most famous, is its non-compulsory character and the lack of sanction mechanisms in case of violation. The disadvantage of bilateral investment treaties is their non-standardized character, although they offer a compulsory framework. In the worst case, each developing country has to agree on an investment treaty with each TNC home country, thereby at the same time conceding TNC from different countries different investment conditions, according to which home country they come from. Besides the fact that this might be a venture difficult to handle both for developing countries and TNCs, a differentiation of FDI inflows according to origin is—with the notable example of a regional integration project—not reasonable from the point of view of Civil Society. By contrast, a developmental framework to regulate FDI seeks to differentiate foreign investment according its potential impact on the host country. Both codes of conduct and bilateral investment treaties have in common the considerable weakening of multilateralism. However, indivisible human rights, equal opportunities and the preservation of the environment are at the heart of multilateralism. Hence, a reasonable regulation on FDI to give developing countries a decent chance to benefit from FDI inflows must be compulsory on a multilateral level, must be open for a special and differential treatment according to the impacts on the host country, and requires a transparent and binding sanction mechanism.
b. *By whom?* Due to its intended multilateral character, international organizations are best suitable to supervise and monitor an international regulation on FDI. However, neither Bretton Woods Institutions nor the WTO are suitable organizations to take over these functions. The Bretton Woods Institutions are already ruled out on the grounds of their feudal allocation of voting rights, which contradicts the required democratic principle of internationally accepted regulation of FDI. Although the WTO formally meets the democratic requirements of a multilateral regulation of FDI, a regulation under the umbrella of the WTO would prohibit developing countries' activities which discriminated in favor of their special interests. Moreover, the failure of the much acclaimed development agenda within the Doha Trade Round and the handling of the so-called Singapore Issues by the institution itself have severely called the role of the WTO into question, as it has appeared to be more a spokesman of the industrialized countries than an active supporter of developmental goals presented in its own preamble. Both Bretton Woods Institutions and the WTO have lost considerable credibility in the international development community, including Civil Society of the South and the North. While the reasons for this loss and the resulting lack of credibility

are manifold, e.g. the inadequate approach to development issues, compared to their goals, the poor performance of the institutions themselves, or the politically biased handling of conditionality (in the case of the Bretton Woods twins), or trade liberalization vs. protectionism (in case of the WTO), the widespread lack of credibility make them unsuited for any multilateral regulation on FDI geared to enforcing a socially and ecologically balanced development process.

c. *The ILO,* of all existing international organizations, seems to be the best suited institution for an international regulation of FDI based on UN standards and the ILO Core Labor Standards. The tripartite character of the ILO guarantees that, in addition to governments and companies, which dominate the political process behind the WTO and the Bretton Woods Institutions, at least trade unions will be an integral part of the process. Furthermore, the involvement of the ILO in international FDI regulation would enhance its status and its binding Core Labor Standards, which have consistently been violated in both the South and the North, the notable example being the US, which does not concede the freedom of association. The achievement of the MDGs requires that the reduction in status of the ILO in comparison with the Bretton Woods twins and the WTO as well as the establishment of shadow institutions and bilateral negotiations rounds be stopped and reversed. But the ILO structure, which is rooted in the beginning of the twentieth century, does not integrate Civil Society as a whole. Hence, an international regulation of FDI, even under the roof of the ILO, would not be sufficient. It would necessarily include a mechanism to provides Civil Society with a procedure for raising objections to investment. Such a mechanism would at the same time result in the empowerment of groups actually affected by the investment, be they local communities, grass root organizations, or religious institutions, thereby contributing to strengthening democratic structures. Even trade unions would benefit from such a mechanism in cases of greenfield investment, before worker representations and trade union activities were formed.

d. I*n whose interest?* An international regulation of FDI as part of a broader developmental framework will be necessary to ensure that activities of foreign investors conform with the development strategy of the host countries. Furthermore, such a regulation would have the potential for enhancing cohesion of national and international politics on developmental goals and especially poverty reduction. The WDR 2005 recommends balancing interests of governments, national and transnational companies and Civil Society. However, the violation of human rights and the irrevocable destruction of the environment can under no circumstances ever be »fairly« balanced with or against profit interests. Policy-makers must be honest enough to admit that the interests of foreign investors do not automatically and in every case serve the interests of society, as the World Bank erroneously assumes. On the other hand, Civil Society is not so naïve as to assume that the interests of society will always serve the interests of all individual investors. Hence, an international regulation of FDI needs to include a conflict resolution mechanism. Without going into too much detail, this Civil Society Report recommends that any foreign investment require a »seal of approval« similar to that required by the Bretton Woods twins. But instead of signing a letter of intent to receive such a seal that would then grant the country access to the international capital market, an international regulation of FDI would require TNCs to sign a letter of disclosure ensuring governments, trade unions and Civil Society of the host countries that the intended investment will not be socially and ecologically harmful. An international regulation of FDI could not guarantee that events like the leak of poison gas would not recur. However, in case of an event like Bhopal, the international framework would oblige such TNCs to financially satisfy the claims for damages of the affected groups. This financial commitment in case of developmental failure by TNCs would induce them to handle their investments more responsibly, as the investment and its possible consequences would no longer provide them a free lunch. Moreover, if such a terrible incident as Bhopal were indeed to recur and the responsible TNC were go bankrupt in the course of the event, the claim for compensation should then automatically be passed over on to the TNC's home-country government. Such a procedure would be a warning and at the same time a financial incentive for industrialized countries' officials not to assume the role of TNC advocacy in such a cavalier manner as the European Union did in the Doha Round with the so-called Singapore Issues on investment and competition, but rather to handle demands from TNCs more cautiously.

10. A Civil Society Critique of the World Development Report 2005: A Better Investment Climate for Everyone (WDR 05)

Peter Lanzet

The World Development Report 2005 is the World Bank's way to tell the developing world »It's the economy, stupid!« as former US- President Clinton once reminded his election campaigners. A team of sixteen World Bank staff supported by bank employees across the World Bank Group, coordinated by Warrick Smith and Mary Hallward-Driemeier under the direction of the new World Bank Chief Economist François Bourguignon has accomplished a daunting task. From the citadel of development economics, we thus receive a massive piece of well-structured synthesis of hundreds of studies, a plethora of data and globally collected best-practice examples. The team deserves our appreciation for stressing the importance of investment for development with a substantial piece of work that meets many requirements.

It presents this subject in the necessary detail, without making it too long. It offers tremendous learning opportunities for policy-makers in developing countries and the global aid system, not least for Civil Society researchers and activists. To do that, it uses tested modes of presentation: E.g. a hypothesis based on a literature synthesis is substantiated by well-prepared statistical data references and then followed up by an episode or two to illustrate the argument. The analysis is always crisp and to the point, the argumentation conclusive. There are parts that can be used like a handbook. No doubt, this report will have considerable impact on policy-makers.

So why is Civil Society not happy?

Among the not so controversial parts of the WDR 05 are the areas where the Bank's team sides clearly with the relative definition in the »pro-poor growth«- debate inside the Bank, meaning it advocates for a greater share of the overall growth for the lower deciles of the Gini coefficient rather than for the upper ones. When the Bank's team recommends the distribution of assets (e.g. land) to the poor to strengthen their eligibility for loans, it is finally taking up an old civil-society demand. Sometimes one is led to think that the WDR 05 team has finally made a departure from the supply-side ghosts of the past. Terms like »capital control« or »selective intervention,« outlawed not too long ago, are now part of the vocabulary of the report, albeit in the negative, as we shall see. In some subsections of the report, the team considers the importance of the informal sector of the economy, and of investment in this economic realm of the poor, as a poverty reduction tool. This is still new as a macroeconomic policy recommendation of the Bank. Its elaborations on corruption and rent seeking and its plea for utmost transparency by all stakeholders in the context of investment policy are appreciated.

The *WDR 05* is a flagship report. It touches indeed on most issues connected to investment. A critique must focus on the comparative attention or neglection themes receive. It is not, e.g. that *WDR 05* does not deal with the informal sector of the economy or does not consider the state as an investor, but is the treatment of those issues appropriate? A noticeable difference between the Overview and the text of the report is perceived. The overview seems decidedly more Pro Poor Policy oriented than the body of the text. One might be safe to assume, the overview is how the management of the Bank wants this WDR to be seen. Yet, the text contains the actual policy advice provided for policy makers. The reader may be assured, this critique is based on the full text.

WDR 05 is based on the ideology of Monterrey

Monterrey is the point of departure for the *WDR 05.* The Consensus of some 160 governments at the International Conference on Finance for Development in March 2002 in Monterrey, Mexico, rests on a basic tenet: Developing countries will be able to finance achievement the Millennium Development Goals largely on the basis on their own efforts. The global structures require only scant modifications, such as some concessions of the rich countries on global trade. The Monterrey Consensus considers investment, and particularly Foreign Direct Investment (FDI), as one of the main sources from which poor countries are to finance their own efforts (Others were selective debt reduction, remittances, and a bit more ODA, made more effective through better cooperation of the Bretton Woods twins with the UN-system). The report does not question the existing global structures in finance and governance. Monterrey promises: If only poor countries create the right investment climate, they will be able to catch up economically soon.

Civil Society does not share this ideology

No doubt, homegrown structural causes of impoverisation in developing countries must be dissolved by themselves. Yet, it is self-deception to believe that the development of the poor countries will be possible without a change in the a. m. global structures which help to keep them poor. The economic catching-up process must be one in which the poor play their part in micro and macroeconomic pro-poor policy-making, at all levels. Looking from this perspective at the WDR 05 , reveals itself to be satisfied with the status quo. The points which Civil Society rejects include:

WDR 05 is not based on a pro-poor-growth approach

There seems to be a group of economists in the Bank who believe that growth with redistribution reduces poverty faster and makes it more sustainable than undifferentiated growth. Yet while in it's initial chapter the *WDR 05* sides with this seemingly obvious, yet loaded assumption, it has not turned this position into a methodology through which it could become policy advice in the area of investment climate.

The team is proud to inform us that new micro-data are now available on the basis of which much of the new investment analysis rests. But the »World Business Environment Survey,« »Investment Climate Surveys,« and »Doing Business Indicators« referred to do not systematically address the informal sector of the economy, despite its size and importance. As the report points out, the informal sector of the economy contributes 50% to the GNI in Latin America, 45-85 % in various parts of Asia and more than 79% in Africa. We learn that one thousand micro-finance programs, 30 million borrowers and \$3.5 billion in loans averaging \$280 exist. There is no micro-business data available to support investment policy making for the informal sector. Only 3 of over 50 questions in the standard Investment Climate and the Country Investment Climate Tables allow conclusions regarding the informal sector. Without data, the investment conditions of the informal micro-entrepreneurs, self-employed service providers, informal family firms, groups and collectives of rural and peri-urban producers and providers remains relatively veiled compared to the formal sector. Even if the WDR 05 wanted to know more about fostering the investment climate in the informal sector, the data is not available. Here the Bank needs to take steps. But, contrary to the WDR 05 assumption the formal and the informal sectors do not always respond to the same attempts to improve the investment climate. Coercion/ non-protection, tradition, and non- access have a much deeper hold over people in the informal sector than in the formal.

The *WDR 05* notes an increase in loan extension of informal banks without collateral, and suggests that lenders who do not take deposits should not be over-regulated. We sincerely hope the Basel committee on banking supervision heeds this plea. Because its fixation on risk threatens to increase interest rates even in developing countries[44]. The WDR 05 also reflects on the type of tax and regulatory system that could encourage an informal entrepreneur to go formal. But whenever the question of

[44] Metzger, Martina: Benefits for Developing Countries, Berliner Institut für Finanzmarktforschung, BIF Working Papers on Financial Markets 2, 2004

support policies for the informal or any other sector of the economy would be a logical consequence, that step is avoided.

Despite the enormous range of the study, it cannot possibly present an investment climate study of every developing country. Thus, the team uses some guiding principles, on the basis of which it presents its analysis and its advice. These however, can be read only between the lines, worse still, they seem to keep changing, reflecting cracks and crevices within the teams thinking as a whole. In the introductory parts of the study, the role of the state is defined as that of a manager to meet economic and social goals. Redistribution of assets and land to the poor is supported by the authors in order to providing them with collateral to mobilize more loans and realize their entrepreneurial dreams. But a Civil Society readers enthusiasm about the inclusion of some of the Deininger agrarian reform recommendations is soon chilled.

When markets fail, the buffer is employment

The *WDR 05* does not look into the reality of investment leading to growth without employment or growth without distribution. WDR 05 reflects an image of the world of neoclassic social-security in Chapter: »Helping Workers Cope«. Ideas such as severance pay, retraining programs, workers flexibility, good investment and competition policies as well as social-security programs that are a part of workers pay are recommended, in order not to discourage investment.

That is a rather poor showing, in view of the fact that the main buffer for market adaptation is seen in employment. Interest rates depend on the markets, the currency value depends on the markets, sector policies may distort the markets. In this system the workers and their families are the sole buffer of the boom and bust cycles of the markets. Moving to new locations on demand, working hours according to a just-in-time system, working under conditions and for pay below those of competitors and finally unrestrained retrenchment form part of the WDR 05 labor recipe for improving the investment climate. Development has more to do with people then with markets. The WDR 05 has no development perspective in the Chapter on »Workers and Labor Markets«.

Selective Intervention and the state as an investor:

Chapter I sees Governments as managers between creating a favorable investment climate and ensuring other social goals, such as employment and keeping the political economy in equilibrium. For concretization, we can look e.g. at the »Selective Interventions« chapter. Here we are advised that if anything, the state has to intervene only because of pressures of the political economy, and that it had better be aware of moral hazards, corruption and market distortion. White-elephant examples are quoted, not quoted are positive experiences. WDR 05 is discouraging governments from adopting any selective intervention policies; it warns against rent seekers, and calls intervention a gamble. So great is the WDR 05's aversion against governments' selective support policies that they advice direct money transfers to help the poor, rather than supporting firms to create employment.

Perhaps because of the fact that the *WDR 05* looks at all forms of private investment, it does not really look at governments as investors—an astonishing fact, given their importance as investors. In India, China and Uganda e.g. Governments invest roughly half as much as private investors. In which areas and under which conditions governments have been and are successful investors is not a subject of the Report—a clear flaw. Given the share of Governments as investors in total investment, given the important macroeconomic role Government investment assumes for support of growth, not to provide a differentiated picture of it is unacceptable.

Six lessons of experience in selective Government intervention are provided. Only one and a half of these may not offend the intelligence of policy-makers from the South. Among others, the *WDR 05* speaks of making selective interventions time bound and subject to regular review. This relates to a whole range of industrial, commercial and agricultural policies. The careful nurturing of infant industries to continuously challenge them to measure up with international competition, but only to the extent that they do not fold up and lose their employment potential, would be a worthy subject for a development agency like the World Bank. WDR05 informs that the Bank conducts a forum for utility regulators worldwide. But their learning is not revealed.

The »Race to the Bottom«

WDR 05 maintains that there is little evidence to support concerns in the environmental field. Yet, the world is full of examples of mindless misuse of the environment by companies in order to save costs under competitive pressure. This is a formidable field of for Civil Society protest, where natural reserves, habitats, cultures and traditions are bulldozered, workers accept dangerous and health-damaging working conditions, or neighborhoods are affected by hazardous emissions and effluents. What does it mean when the *WDR 05* says that the environment is only a part of an investment decision. Experience is not that corporations tolerate higher cost for a cleaner environment, although environmental costs are not the main consideration in their investment decision. Experience is that corporations preserve the environment only when their market reputation is about to be tarnished by public protest. Civil Society has not yet systematically evaluated the UN General Secretary's Global Compact. But the experience with the observation of a multitude of Corporate Social Responsibility Standards and Codes of Conduct is disappointing.[45]

The race to the bottom is a systemic argument, pointing to the need for regulation. If not environmental and labor standards tend to erode. There exists a basic contradiction between the goal of poverty reduction on the one hand and investor demands for lower taxes, lower wages, less regulation and privatization of basic services on the other. The WDR team adopts the benign view, that with higher productivity and income, people will want a cleaner environment, better health and better working conditions, and that firms are interested in a clean reputation. Look at the agreements German auto workers are being forced to enter into with their employers to prevent them from relocating their investments in the accession countries of the EU, which offer tempting labor cost and regulation advantages.

WDR05 perceives the evidence that a race to the bottom is really happening as mixed. But instead of exploring the question with the full power and the wealth of data available to the Bank, it takes a distant stance and diagnoses tensions and divergent interests. Seeing the struggle of the enlarged European Community in the EU/ECOFIN affected by relocation of industries, in part kicked off by countries using corporate taxes for competition, it declares the search for meaningful regulation to be in vain, because if corporate taxation is regulated, countries will find other sweeteners to welcome investment. From a development perspective one would see the overall responsibilities of the state to its citizens and seek for ways to ensure its financing. That is a foreign concept to this WDR.

The enclosed EED- Civil Society Report on FDI shows how TNCs are becoming ever more skilled in »transfer pricing,« in »thin capitalization« and the registration of holding companies in international tax havens. The International Tax Justice network believes that more then half of the VAT actually accruing in multi-centered TNC production is never paid. The *WDR 05* itself admits that if capital is mobile and labor is not, a greater share of the tax burden will fall on labor. A Civil Society perspective would conclude, FDI requires global labor, social and environmental regulations (see Chapter 9 of the EED-Civil Society report).

FDI removed to the backstage

As a separate subject among all other sources of investment, FDI gets ten pages of a 250 or so page report. But not only quantitatively FDI is underrepresented in the *WDR 05* (see Chapter 2). Concerns are:

a) Balance of Payment (BOP-) concerns are of particular importance as FDI has a macroeconomic leverage on interest rates, currency volatility, capital and current accounts, and hence on the overall integrity of the finances of a country, which domestic investment does not have. The report does not look into the extent to which FDI

[45] Köpke, Ronal, Röhr, Wolfgang: Codes of Conduct: Verhaltensnormen Transnationaler Unternehmen und ihre Überwachung, Köln 2003 .

has increased the need for more foreign exchange in terms of follow-up import requirements, profit repatriation, non-generation of sufficient import savings, and non-generation of sufficient exports. How can a statement like »greenfield investment is difficult to reverse« be taken at face value, when examples of footloose investment like the relocation of maquila textile investments to Asia are such a growing threat? Why has the team not addressed David Woodward's[46] pertinent critique of FDI as a BOP crisis waiting to happen? He makes a clear case that positive effects arise only where new productive capacity is created in the export sector, or in very strongly import-substituting sectors. If FDI takes the form of the purchase of existing domestic industries, even in the export sector, it will have a negative foreign exchange effect even if export production goes up, unless the productivity of capital increases enough to offset other increased foreign exchange costs. If not enough imports are substituted, the effects of »greenfield« FDI on the BOP may be much more ambiguous, and may be negative. The EED- Civil Society FDI-Report includes a model calculation based on conservative assumptions whereby, an initial FDI of € 200 m breeds a debt of € 284 m over a period of 30 years.

Against such pertinent concerns, the WDR 05's messages seem to be carelessly positive: FDI, especially greenfield investment, can only be good for economic growth. There is no warning against critical BOP developments, there is no call for early warning systems to be established. A six-line marker tucked away under Box 5.12 advises against banks lending foreign currency to companies earning only domestic currency. Indeed, the BOP treatment in the FDI parts of the *WDR 05* borders on the irresponsible. On capital control WDR 05 accepts that it may be helpful to redirect FDI toward greenfield investment. Yet the overall warning advises against them, as the increase the cost of borrowing and restrain FDI availability. It is as if their had never been an Asia crisis and the role of footloose and speculative FDI in it.

b) Spillovers are seen at various policy levels by *WDR 05*, and are said to happen more at vertical lines of productions than at horizontal ones, where many produce more or less the same things at the same level of productivity. These rather unsurprising findings are coupled with the information that FDI spillovers happen more in economies with a broad basis of local suppliers, so that small economies will find it difficult to profit from EPZ. It can thus be concluded that FDI does not automatically generate positive spillovers by itself, it needs regulation. Yet, *WDR 05* is not in favor of spillover regulation. The reflections in the EED Civil Society FDI- Report allow the conclusion that for spillovers to happen, a country depends on (a) local conditions, such as sufficiently developed financial markets or the country's already existing highly educated workforce; and (b) its ability to regulate and tailor FDI inflows (see Chapters 3 and 7).
c) EPZs or »enclaves« as the *WDR 05* calls them, are seen as a beginning, a turnaround from fossilized economic structures towards growth. Spillovers , as we saw, depend on the size and structure of the economy. The problem with EPZs is regulation. On regulation, the *WDR 05's* word is »fine-tuning,« which means throwing most of regulations overboard and strengthening the skills and expertise of the regulators before you put new ones in place. WDR 05 wants regulation firmly rooted in growth orientation and as far away from the realm of the political economy as possible.

EPZs are an expression of the race to the bottom. Civil Society wants regulation (1) to safeguard the interests of the poor; (2) to foster growth; and (3) to redistribute the gains of growth—in that order. The WDR 05 puts (2) ahead of (1), and sees (3) as a variable of the market. The relative definition of pro poor growth, which is a market-based attempt to ensure more equality and hasten poverty reduction, needs the state, not the market, to guide the redistribution of growth. Unless global reg-

[46] David Woodward (The next crisis? Direct and Equity Investment in Developing Countries; Zed Books, London and New York, 2001) .

ulations are accepted everywhere and enforced by the state, there will be violations of core labor and environment standards, and spillovers may not happen sufficiently.

The EED-Civil Society Report on FDI shows that the net benefit of FDI for countries declines with increased competition for investment. The more governments try to improve their investment climate by reducing corporate income taxes and abolishing regulations and performance requirements, the smaller are the benefits from FDI for society as a whole.

Openness to International Trade

The *WDR 05* argument is: Few countries have experienced growth without being open to trade. WDR 05 quotes Chang (»Kicking away the Ladder«) in reference to the promotion of wool manufacturing by the 14th century English monarchy. But Chang's main argument is that today's strong economies have all protected their industries until their productivity had reached the point where market openness became a benefit to them. The WDR team does not consider this historical experience. At what level of development of a nation's markets and sector productivity it becomes meaningful to open up to wider competition is not a question being examined.

The *WDR 05* makes much of the $85 billion cost that firms in developing countries get saddled with as a result of market protection regulations of their Governments. However, *WDR 05* does not account for the social, health and educational cost of families as a result of lack of income due to retrenchment or loss of employment, nor does it account for the additional cost to the social security budget of these countries. How can a West African Government be open to subsidized food imports? Food producers in the country will never be in a position to compete with the unfair export dumping practices of the EU. How open is the US for cotton from Mali?

The *WDR 05* acknowledges that a Government has to manage the tension between the investment needs and the political economy of the country. But their is no effort to compute the overall societal cost of opening up sectors to international competition ahead of their survival capacity. Instead WDR 05 laments the higher prices firms have to pay, because markets are protected. From a development perspective price is not everything. How is the transition to be managed? The subject of coaching and catching -up management needs to be worked out as part of e.g. an industrial policy. Again, why is the experience of the forum of utility regulators not integrated in the report?

International Rules and Standards

For the dispute arbitration between states and investors, the *WDR05* team recommends an in-house solution. The World Bank's own »International Centre for the Settlement of Investment Disputes (ICSID)« is presented as the proper channel for arbitration. For a sovereign to accept a third party like the UNCITRAL to mediate in quarrels with firms would be difficult enough, but to expect sovereigns to voluntarily accept a private sector advocate like the World Bank in this mediation role may not be realistic. Transparency throughout the more then 2000 existing bilateral investment agreements, etc is needed. Global compulsory regulation for FDI in particular is an overdue requirement. It should aim at improving the external position of developing countries, be neutral to typical boom-and-bust-cycles, generate net employment for the domestic workforce, increase its productivity, ensure core labor standards and social security, up-grade technology, ensure forward and backward linkages, especially with SMEs and maintaining environment and biodiversity.

Civil Society takes note of the *WDR05* appreciation for its pressing firms to adhere to Corporate Social Responsibility Criteria, in order to keep their market reputation unspoiled by sweatshop smells. But the experience is negative. Civil Society believes in judicable regulations more than in voluntary commitments.

Concluding, when it comes to reducing risks and costs for the private sector to improve the investment climate, the *WDR 05* recommendation is: Yes. When it comes to regulate taxes, competition, spillovers, etc. to prevent the race to the bottom, the advice is »No.« Civil Society is not really surprised. The *WDR 05* has not taken leave from the Washington Consensus at all. The world's principle development bank has no development perspective of the global economy.

Instead, it tells the world: »It's the economy, stupid.« Fortunately for the Bank, this is not about an election. For if it were, the Bank would lose!

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The Berlin Institute for Financial Market Research (BIF), is a private research institute of economists and sociologists focusing on financial market issues. It works on international economic relations and macroeconomic policies. (*www.bif-berlin.de*)

The Berliner Landesarbeitsgemeinschaft Umwelt und Entwicklung (Berlin County Working Group on Development and Environment BLUE 21) works on world trade, international capital markets and indebtedness. (*www.blue21.de*)

The Centre for Policy Dialogue (CPD) promotes an ongoing process of dialogue between the principal partners in the decision making and implementing process. The Centre brings together ministers, members of parliament, business, NGOs, donors and professionals. (*www.cpd-bangladesh.org*)

The Church Development Service (EED), an Association of the Protestant Churches in Germany, promotes the programs of partnerorganisations, monitors development policies of Governments and Mulitlateral Institutions with an aim to ensure Peace, Justice and Human Rights. (*www.eed.de*)

The Brazilian Institute of Social and Economic Analyses (iBase) strives towards building democracy by fighting inequalities and stimulating citizens' participation. Ibase lends visibility to people living in poverty and social exclusion. (*www.ibase.org.br*)

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