# INVESTMENT FOR DEVELOPMENT: THE CASE OF SEVEN ECONOMIES IN TRANSITION

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# I. Introduction

Foreign Direct Investment essentially deals with the expansion of productive entities (firms) across international boundaries. As firms expand they bring with them many tangibles and intangibles – Capital, machinery, technology, managerial talent and technology, brands, products and processes being some of the most important. Many also consider other intangibles such as cultural aspects to be intimately tied with this expansion. As firms bring in all these, they also 'take out' some others. The most important being the repatriation of surplus of profits.

Given the wide nature of factors involved with FDI, it has also generated strong feelings. The supporters of FDI consider the gains in employment, investment, and as a result on growth to far outweigh any potential pitfalls. Those inimical to FDI consider the dangers such as repatriation of funds, cultural 'invasion', etc., to far outweigh any potential economic benefits.

History has revealed a picture that is far from clear in terms of the 'net' benefits. The trading firms of the colonial days, the exploitation of natural resources, the meddling in the political environment of host countries, are well documented. Modern economic history has however, shown in many different ways the great advantages that foreign direct investment brings with it.

Given these conflicting signals, the question that arises is, "What is the lay-person's view on FDI?". Civil society plays an important role in shaping long term orientation of the common people. These in turn affect the shape and structure of countries' policy towards FDI.

This monograph first deals with the analysis of civil society's views on FDI in seven different project countries. These countries include Bangladesh and India in the South Asian region, South Africa, Zambia and Tanzania in the African region, Brazil in Latin America and Hungary in Eastern Europe. It is based on the papers prepared by the country researchers in the seven countries and the secondary data available from many different sources.

The countries were chosen for many reasons. The objectives in the country choice were primarily related to bringing in a wide range of experiences by including a wide range of countries. Diversity in economic characteristics, geographical spread, and the size of the economy were some of the key factors. In addition CUTS' networking strength also contributed to the choice. There are therefore three groups of countries: Large Emerging Economies - India, South Africa and Brazil and Least Developed Countries (LDCs) - Zambia, Tanzania and Bangladesh. In addition a transition economy – Hungary was also included. Though Hungary has a much higher per capita income and is not exactly a developing country, its study throws up useful insights on the characteristics of FDI not only in transition economies but the development process in general.[1]

Each country's and its society's views are also shaped by their actual experiences. The commercial sections of a society that include entrepreneurs, managers and investors are also playing an

[1] Useful comparative insights were also drawn from the four regional seminars: Africa seminar, 18-19 October 2002 in Nairobi, Kenya; Asia Pacific, 24-25 November 2002 in New Delhi, India, Latin America,4-5 December 2002 in Sao Paulo, Brazil, and Transition Economies of Central and Eastern Europe and Central Asia, 5-6 May 2003, Istanbul, Turkey.

important role in affecting the structure of FDI policy. Their experiences are another important facet of long term policy formulation.

How have their experiences been; How have specific industries/sectors been affected by FDI; Have these experiences been positive; Have there been gains for specific sectors; are other important questions that are dealt with in this part of the study. This monograph also synthesizes these issues related to the reports on the seven mentioned project countries.

In sum, the objective of this paper is to identify sensible and sustainable policy measures. Policy measures that are sustainable are those that receive widespread public support; an understanding of the views of civil society becomes important in that respect as well. These views have in part been shaped by the experiences of individual countries. Knowledge of cases in a range of sectors helps us identify direction that sensible economic policy in general and FDI policy in particular should take.

Investment leads to capital accumulation. Capital accumulation is the primary determinant of growth. Foreign Direct Investment leads to much more. Technology improvements, productivity spill-over, and skill-enhancement due to FDI projects permeate the entire economy over a period of time.

Not all countries, however, have been equally successful in achieving this objective. Apart from other objectives, the *Investment for Development Project* seeks to develop a better understanding of how developing countries can stimulate investment, especially foreign direct investment. A lot has already been written on the subject and therefore, this project takes a different route. It seeks to derive incremental insights from the comparative analysis of experiences of seven countries that represent different backgrounds and socio-economic environments. The countries selected are Bangladesh and India in the South Asian region, South Africa, Zambia and Tanzania in the African region, Brazil in Latin America and Hungary in Eastern Europe. This paper provides an assessment of the key issues. This is based on the papers prepared by the country researchers in the seven countries and the secondary data available from various international agencies.

Broadly, the synthesis seeks to explore three interrelated questions:
1. How are countries trying to increase FDI?
2. What have been the actions undertaken by countries and how have they fared?
3. How has the general impact of FDI been?

Answering these questions requires us to have a good understanding of FDI. However, we find that though there is a very elaborate theoretical framework for understanding FDI, it has some gaps that make it difficult for us to derive policy prescriptions *purely* from theory. This has further necessitated answers based on empirical analysis of the project countries.

The task therefore is two-fold: to find, and to report. Given the complex relationships and determinants we try and separate the two tasks. Much of the empirical exercise conducted is reported in the Appendix. This monograph instead concentrates on the description of the factors, the conditions in the project countries, and most importantly on the findings on how those are related to actual FDI.

The rest of the paper is divided into five sections. Section 2 summarises the key determinants of FDI by way of a brief literature summary. Section 3 discusses the broad macro and policy characteristics of the project countries. The focus is on those features that can contribute to FDI flows. Section 4 analyses the trends and patterns of FDI in line with the policies and policy changes. International trends in the outward and inward flows of FDI since 1970 provide the context for the analysis of FDI trends in the seven project countries. The role of FDI in the project economies, its contribution to capital formation, output etc. is also discussed in this section. Section 5 identifies if policies had contributed to the utilisation of the potential to attract FDI in the project countries. An effort is also made here to derive some policy lessons to attract FDI in the project countries. The concluding section analyses the experience of the project countries in the context of the changing policy and economic environment of the nineties and raises some questions about the role of FDI in the emerging international economic situation.

# II. What affects FDI[2]

FDI can essentially be seen as the expansion of firms across borders. A firm would only expand from its base (home country) if it expects to generate high enough surpluses for it to justify investing across large distances. If a firm generates enough surpluses from any other means (such as exports) then it need not invest. In other words, **FDI only occurs when there is no other means of international economic interaction that can be expected to generate higher surpluses**.

This section first identifies the three broad motives that justify any type of international economic interaction. If these three motives are met, only then is FDI a possibility. However, for FDI to fructify other factors internal and external to the firm also have to be present. These factors can best be but together by the Ownership-Location-Internalisation (OLI) framework, which is discussed in subsection II.2.

## II.1 The Three Broad Motives of International Economic Interaction

Broadly, three types of motives have been identified: (a) Market seeking; (b) Resource/asset seeking; and (c) Efficiency seeking. These are briefly discussed below.

*Exhibit 1*

**Type of FDI classified by motives of TNCs and principle economic determinants in host countries**

| |
|---|
| ***A. Market-seeking Motive*** |
| *Depends upon:*<br>• Market size and per capita income<br>• Market growth<br>• Access to regional and global markets<br>• Country-specific consumer preferences (e.g. importance/exposure to foreign brands)<br>• Structure of markets (presence of competition, or incumbent monopolies) |
| ***B. Resource/Asset seeking Motive*** |

[2] The discussion in this section draws heavily from UNCTAD (1998).

| |
|---|
| *Depends upon:*<br>• Raw materials<br>• Low-cost unskilled labour<br>• Skilled labour<br>• Technological, innovatory and other created assets (e.g. brands)<br>• Physical infrastructure (presence of ports, roads, power, telecommunication) |
| ***C. Efficiency-seeking Motive*** |
| *Depends upon:*<br>• Cost of resources and assets<br>• Other input costs, e.g. Transport and communication cost to/from and within host economy and costs of other intermediate products<br>• Membership of a regional integration agreement conductive to the establishment of regional corporate networks |

Source: Adapted from UNCTAD (1998), p 91.

The importance of different location specific determinants varies according to motives (see Exhibit 1). *Market seeking investors* are likely to be attracted by the potential sales in host country markets. Consequently, markets that are large, growing and that can be used to access regional markets will be most attractive.

*If resource/asset seeking* were the prime motive, availability and cost or accessing raw materials, other specialized assets, skilled and unskilled labour would be critical for making investment profitable.

Firms may also invest in a country to benefit from *efficiencies* arising from externalities. Here the efficiency of resource use is critical. Costs of labour, infrastructure etc. will be the key variables here. Externalities/ spillover benefits could be derived through regional economic arrangements (including clusters) that give rise to economies of scale and scope.

These potential benefits are two sided. As long as there is competition and monopolies do not come into being, host countries and their residents gain as well. This is presented in Exhibit 2.

*Exhibit 2*

| **Benefits to Host Country** | **Areas of Caution** |
|---|---|
| *A. Market-seeking* | |
| • Training and skill enhancement<br>• Employment opportunities<br>• Greater range of products<br>• Lower prices of products | • Exploitative if monopoly in essential items<br>• Gains are maximum when competition exists in product markets |
| *B. Resource/asset seeking* | |
| • Training and skill enhancement<br>• Employment opportunities<br>• Reduce waste of human and physical resources | • Can be exploitative if monopoly in factor markets<br>• Long term contracts combined with monopoly |
| *C. Efficiency-seeking* | |

| | |
|---|---|
| • Utilization of inherent strengths of host country<br>• Overall productivity gains | • Policies and incentives such as subsidies tend to neutralize the gains to the economy |
| Investment, employment, technology and skill improvement occur in all cases. Of these, technology and skill improvements also spread throughout the economy over a period of time. | |

However, just because a country possesses resource, market or efficiency advantages does not imply that FDI will actually occur. Take for instance the case of a country that has very good market for Black Cola. It does not imply that an MNC will invest in that country. It could have a long-term contract with a domestic producer who could be manufacturing it under licence. Or it could simply export Black Cola to the country. Similarly take the case where a country has a very good human resource base to produce software. That does not necessarily imply that an MNC will have a resource seeking investment in that country. It could merely contract out the software development to a firm from the host country and purchase the final software.

In other words, *something else* has to be present before an MNC would be interested in investing. That something can best be studied with the help of the OLI framework.

### II.2 The Ownership-Location-Internalisation (OLI) Framework

FDI comes under many different forms. Joint ventures, subsidiaries, branches, are some of the most well known forms. According to the OLI framework, the presence of ownership-specific competitive advantages in a firm, location-specific advantages of the host economies and superiority of intra-firm transactions (internalisation) over arm's length transactions results in FDI.

- *Ownership-specific Advantage* - Firms that have acquired some firm-specific capability sometimes find that they must operate through a foreign subsidiary in order to fully exploit that competence. For example, advantages based on proprietary technology or brand names may compensate for additional costs of establishing production facilities in a foreign economy. In fact, they can overcome "foreign" firm's disadvantages vis-à-vis local firms, arising out of "distance costs and the relative lack of familiarity".
- *Location-specific Advantage* - Firms establish a subsidiary in a foreign country to take advantage of a large market, lower cost structure or a superior infrastructure of that country.
- *Internalisation Advantage* - Firms find greater benefits in exploiting both ownership and location advantages by internalisation rather than arm's length transactions. Such advantages may arise due to imperfections in the market for assets and inputs, especially those relating to technology and management. These imperfections may not only involve significant transaction costs but may also reduce the appropriability of the ownership advantages (e.g., patents etc.) that the firm may have. Such imperfections are likely to be more significant in earlier phases of the product/technology/industry life cycle.

It can be seen that the first and third conditions are firm-specific determinants of FDI and essentially influence the probability and extent of investing abroad. The second set of conditions is location specific and has an influence on the location of FDI. It is the location specific conditions

that the host country governments can influence in order to attract FDI.[3] Consequently, *various policy instruments can be used to enhance the location specific advantages of the host countries.*

***Box 1***

**Imperfections in the International Capital Markets: Another form of Localization?**

Aliber (1993) has emphasised. It has been argued that patterns of FDI are determined by exchange risk and the market preferences for holding assets denominated in selected currencies. *Ceteris paribus*, capital can flow from countries with low interest rates to those where foreign exchange risk adjusted interest rates are high. Thus, when due to interest rate differentials, returns on foreign investments (corrected for expected foreign exchange depreciation) are higher than on domestic investments, enterprises invest abroad. Exchange rate fluctuations can also influence FDI inflows. The basic idea is that depreciation of the host country currency will give foreign enterprises the ability to outbid domestic firms because of the increased value of their capital. This may lead to inflows in various forms: expansion of production operations, entry into new foreign markets, reinvestment of earnings or consolidation of market power through M&A activity. On the other hand exchange rate volatility may impede FDI as it increases uncertainty regarding the returns to investment. Some empirical evidence suggests that as compared to exchange rate levels, volatility of exchange rate is a more important concern for FDI inflows, although not uniformly across all countries (UNCTAD, 1993).[1]

This explanation is highly dependent upon the relative differences in the exchange rates and volatilities between home and host countries. Arguably, it could therefore be subsumed under the OLI framework.

The key advantage of the OLI framework is that it broadly identifies all the factors that matter. In that sense, this is also a serious dis-advantage. A careful reading of this framework leads one to the conclusion that almost *everything* matters. Moreover, this framework does not reveal which factors matter more.

**As a consequence, policy makers cannot gain much from studying the OLI. Since the possible policies and actions are boundless, we need to focus on a few things that matter the most. The importance of this project should be seen in this light. By focussing on a range of developing countries spread across four continents, with different economies and levels of development, it seeks to empirically determine which factors matter, and which factors matter more.**

### II.3 Cross-country Comparisons of FDI Inflows: Role of Structural and Policy Variables

While all the project countries can be characterized as developing, they are disparate in terms of population size, per capita income, levels of economic development, their political economy, and their policies towards FDI. Therefore, before we can answer the question: "How successful have these countries been in attracting FDI?" we need a prior structure where in to study the determinants of FDI, that are empirically grounded.

We know that broadly FDI seeks markets, resources and efficiency; and that when other conditions are present, it occurs in different forms. One possible way of studying is to differentiate between *structural* and *policy* factors. Structural factors are considered here to be those that are inherent to the host economy/country and are not affected directly by policy. *Policy* related factors on the other hand are those that can be altered or changed by policy.

[3] One can argue that location specific conditions also influence market imperfections and therefore cost of transactions and internalisation.

*Structural factors* capture factors such as market size and growth (market seeking), natural resource endowment (resource seeking) and efficiency of production (efficiency seeking). It is difficult to get data on well-defined variables that directly capture these factors. However, it is possible to derive good proxies for the same. National income, its growth and per capita incomes are used to capture the size of the market and its growth. Since a direct measure of natural resource endowment is not available, reliance on imported manufactured products is used as an indirect measure for resource seeking possibilities.[4]

We find that even when we consider a wide range of countries (135 countries) these factors can explain as much as 50 per cent of the inter-country differences in FDI. That is, we find that just these three factors (pointed below) account for a very large part of the FDI across the world.

- Market size (as a variable capturing market seeking potential)
- Growth of the market (once again captures market seeking possibilities)
- Natural resource endowment (a variable to capture resource seeking potential)

Thus, market-seeking possibilities arising from a large economy and the natural endowment based resource-seeking turn out to be key structural determinants of inward FDI. The rest 50 per cent unexplained variation is to a large extent due to policy differences and other qualitative differences across countries.

The role of these structural factors can be even more prominent in specific countries. For example, locations that can serve regional markets can be more attractive "market seeking" locations than what can be predicted on the basis of the market size of that country alone. Note that **a large part of the variation in FDI is explained by the structural factors. This is evidence enough that FDI is primarily a function of the nature of the economy.** This insight cannot be over emphasised.

The analysis outlined above (and discussed in detail in the Appendix) can also be used to predict the quantum of FDI inflows that can be expected in the project countries, given their market size, growth and natural endowments as defined above. These reflect the structural potential of the economy to attract FDI. Good and bad policy can have a positive or negative impact on this *inherent* potential. In a subsequent section we will compare these predicted outcomes with the observed flows of FDI. This will help on the assessment of the relationship between the potential and actual inflows of FDI and how policy initiatives can impinge on this relationship. However, before we can do that, we need to have a better understanding of FDI in the selected countries, and also their economic and socio-economic conditions.

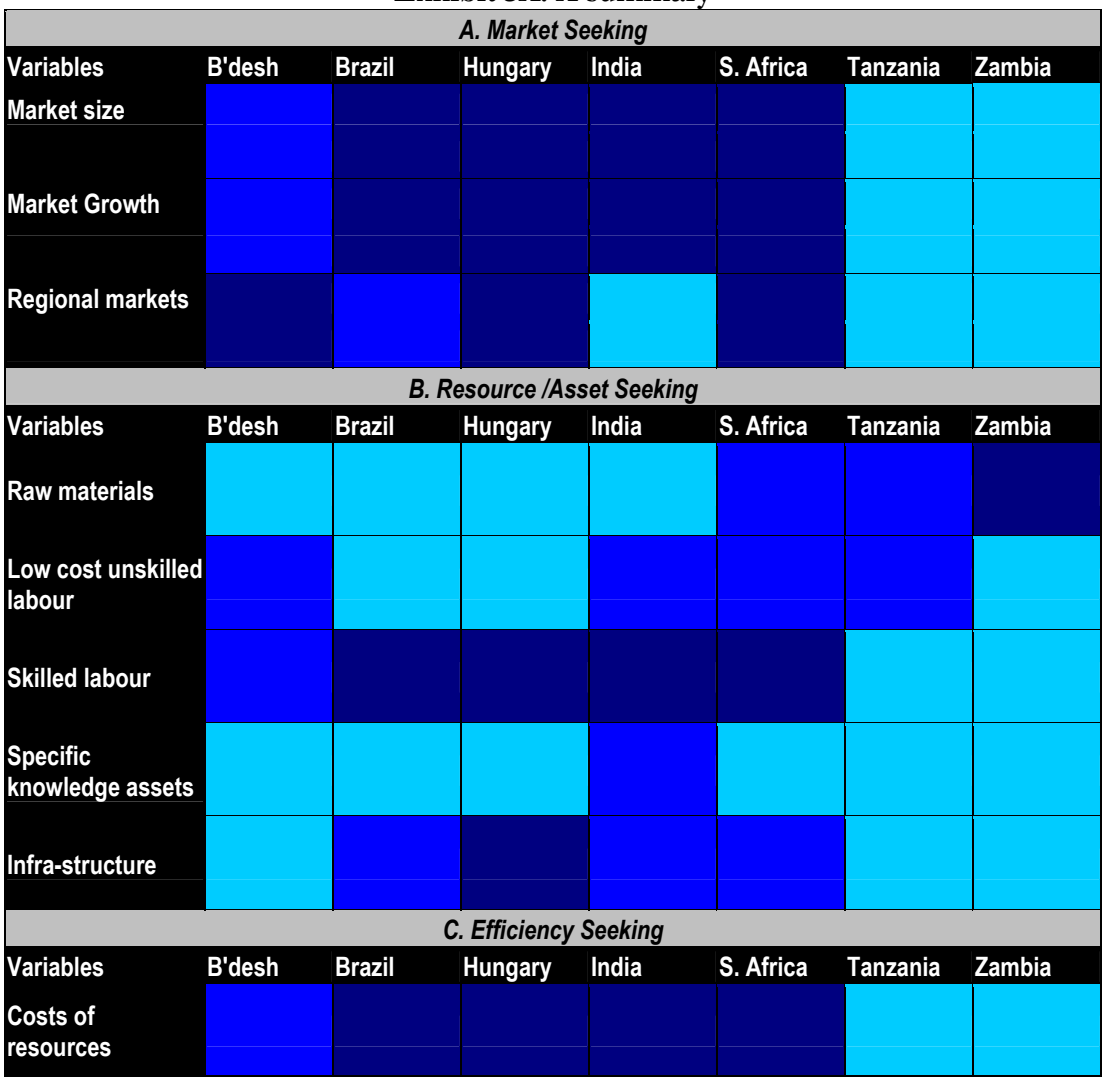
### III.5 Policy and Structure: A Brief Summary

This section has analysed a wide range of issues for each of the project countries. Exhibit 3A below summarises the key elements of the discussion above. To do so we must first revisit the key motives for any international economic interaction, and FDI in particular – Market, resource, and efficiency objectives. The various conditions studied all tie into these three motives.

[4] Appendix I provides details of the model and discusses the estimation results.

Exhibit 3A below visually compares how each of the seven countries studied performs with respect to the individual determinants analysed. A darker shade identifies that the country has relatively strong performance in that respect, lighter shade implies relatively lower performance, and the lightest implies least importance. For instance, in the market size criteria Barzil, Hungary, South Africa, and India perform stroger than Brazil which in turn performs stronger than Tanzania and Zambia.

**Exhibit 3A: A summary**




Overall we find that Hungary has the most 'attractive' conditions for the various FDI motives, followed by South Africa and India and Hungary. More importantly, we find that conditions in Zambia are the weakest in terms of the range of motives for which FDI may occur. However, it does perform strongest in terms of the natural resources for the size of its economy.

A relatively poor performance on the above aspects however *should not be taken to imply that there is no scope for FDI, only that attracting greater FDI will be more difficult.* Recall that we have found that these factors at best explain about half of the variation in FDI. Another half is affected by policy related and other factors to which we now turn.

Exhibit 3B below summarizes the conditions that prevail in the project countries. As is true for any summary it does not give the whole picture, but we believe that it broadly identifies the performance with respect to the various policy and structural factors studied. In the exhibit, blue shades reflect relatively positive actions and prevailing conditions, and pink shades reflect relatively unfavourable. Darker shades reflect (positively or negatively) stronger conditions.

As the exhibit shows, Hungary has the strongest *relative* conditions and policies. Note that this is a relative presentation. As we have noted previously, countries have been converging in terms of their FDI related policies and other non-FDI policy related factors have therefore become the determining factors to differentitae those countries.

Take for instance Hungary that shows the most favourable conditions and policies. It performs significantly better than India which is not a member of any trade block, has relatively higher exchange and other risk perception. This despite the fact that India has shown similar liberalism in its FDI related policies.

**Exhibit 3B: A summary**

| *D. Impact of Policies and Other Conditions* | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Variables** | **B'desh** | **Brazil** | **Hungary** | **India** | **S. Africa** | **Tanzania** | **Zambia** |
| **Economic stability** | | | | | | | |
| **Liberal FDI policies (1)** | | | | | | | |
| **Trade blocks** | | | | | | | |
| **Tax breaks & subsidies** | | | | | | | |
| **Perception of capital cost & exchange risk** | | | | | | | |
| **Perception of political and other risks** | | | | | | | |
| | | | | | | | |
| **INDEX** | **HIGHLY FAVOUR-ABLE** | **FAVOUR-ABLE** | **LESS FAV-OURABLE** | **NEGATIVE** | **MORE NEGATIVE** | INFO NOT AVAILABLE | |

Given this overview of conditions and policy we now move to studying how FDI has actually been occurring in project countries.

## IV. Quantum, Patterns and Contribution of FDI in Project countries

This section summarises the patterns of FDI inflows in the project countries. Global trends in FDI are related to the trends in growth, world trade and the differential growth rates of countries. In keeping with our objective of avoiding detailed discussions on specific aspects of these economies, we present the detailed discussion in Appendix II. Only the key findings are highlighted here.

- There have been ***significant fluctuations in the flow of FDI*** to various countries studied. Countries that obtain larger amounts tend to have lower fluctuations. This *lumpiness* in FDI is

natural, as one large investment project can suddenly and temporarily shoot up overall DFI levels.

- ***Sources of FDI are becoming plural*** as firms from more and more countries invest abroad. The dominance of US is on the decline as Europe, Japan and many East Asian countries are becoming important sources of FDI.
- As most countries became both hosts and sources, ***FDI became more akin to 'trade' with both outflows and inflows***.
- Structural adjustments, privatisation and liberal FDI policies have resulted in large FDI flows in the services sector. ***Privatisation has been one of the most important causes of FDI*** in recent years. FDI is crucial to globalisation of the services sector.
- ***FDI cannot be expected to solve the problem of under investment in developing economies by itself***. As such, there is really no case of FDI flow shares of the LDCs as a whole having gone up in the nineties, and therefore, of the optimism that FDI per se can solve the problem of investment.
- There are ***significant inter-regional variations*** in FDI. In the nineties Africa has had the slowest growth in FDI and Latin America and the Caribbean (starting from historical lows after the debt crisis) had significantly higher growth rates. East Asia, of course, has had the highest growth in FDI.

**Overall, the data suggests that market seeking has been the key driver for recent investments. This is followed by natural resource seeking in the African countries and Bangladesh and in limited way efficiency seeking in countries like Brazil, Hungary, India and South Africa.**

**Figure 11: FDI inflows in U$ Mill**

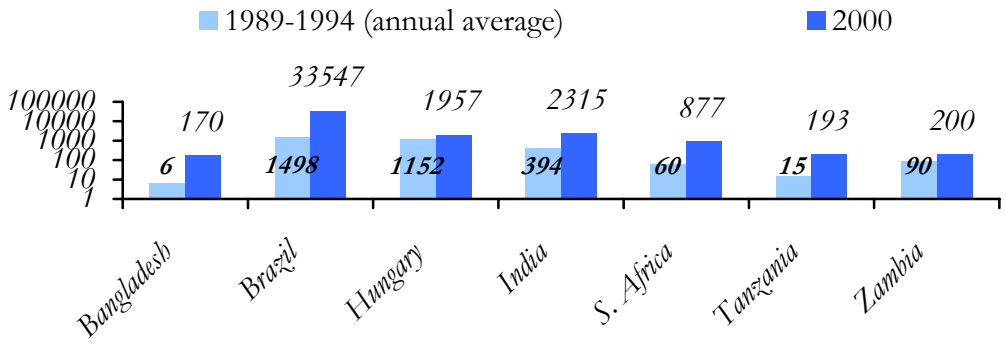



**Figure 13: Inward Stock of FDI in US$ Mill.**

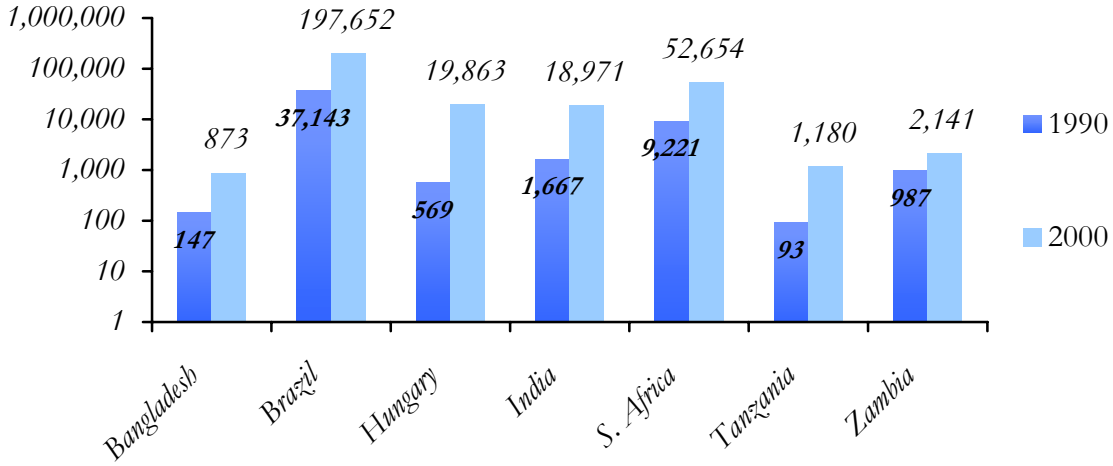
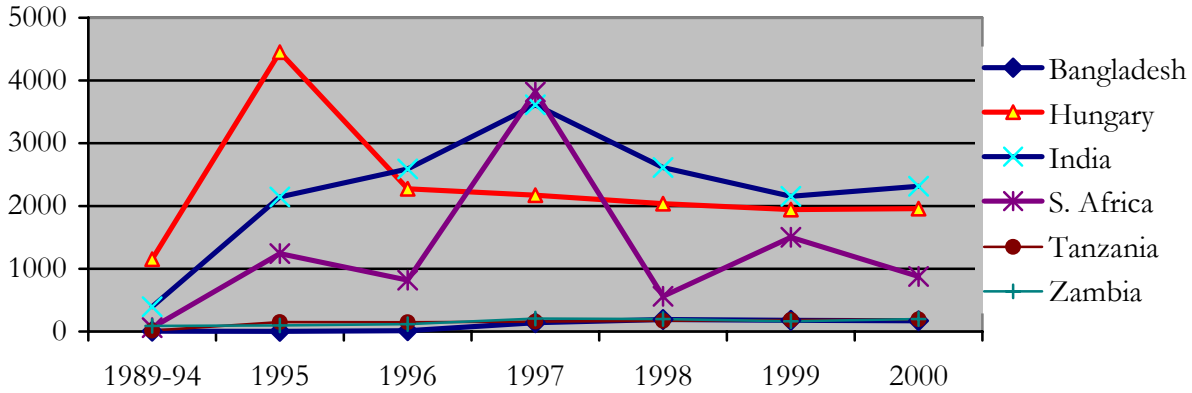



**Figure 15: Yearly Variation in Inward FDI**



### IV.3 Role of FDI in Project countries

Apart from contributing to the up-gradation of knowledge stocks, foreign investment can serve two broad purposes, namely, raise investment and relieve foreign exchange shortages. Insofar as these constitute key constraints to growth in developing countries, FDI has the potential to become an important vehicle of growth. Unless FDI affects national savings, it can either raise domestic investment, provide additional financing for pre-existing current account deficit or achieve some combination of the two. This section discusses various dimensions of the role played by FDI in the project countries.

**Figure 17: Privatization Proceeds, 1998 in US Mill.**

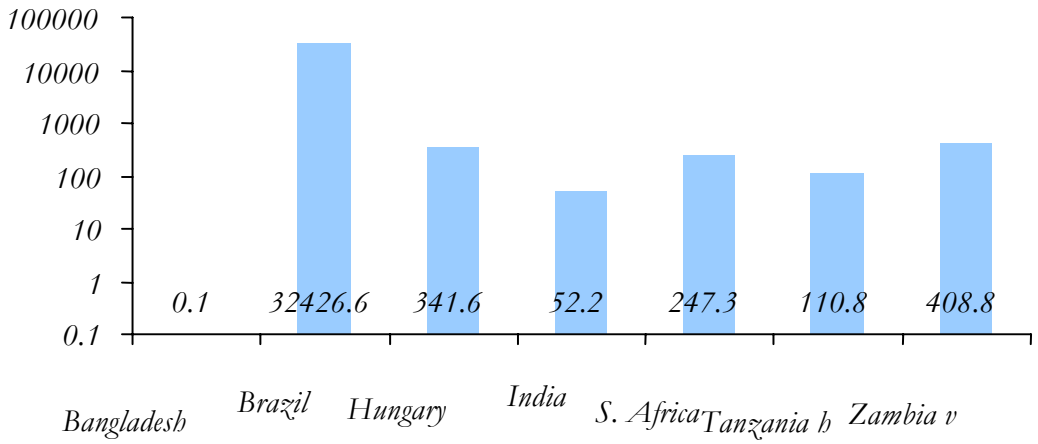



**Figure 18: Cross Border M&A Activity, 2000**

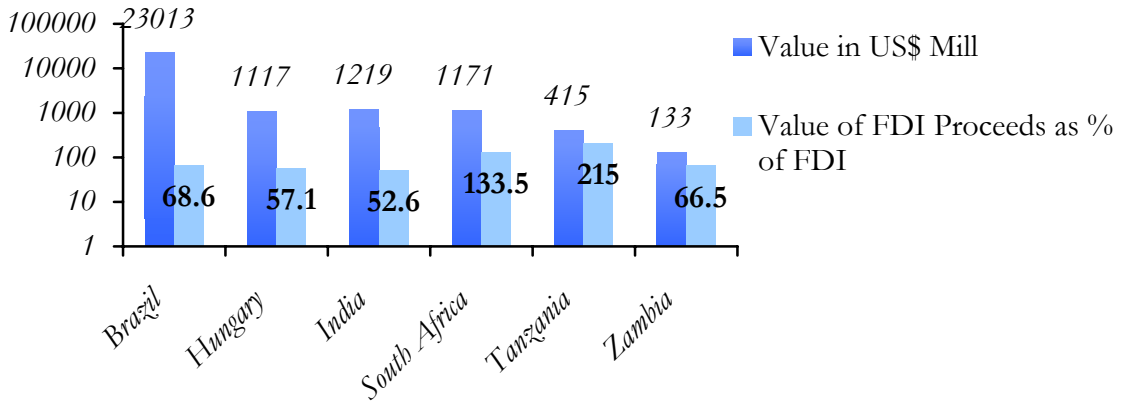
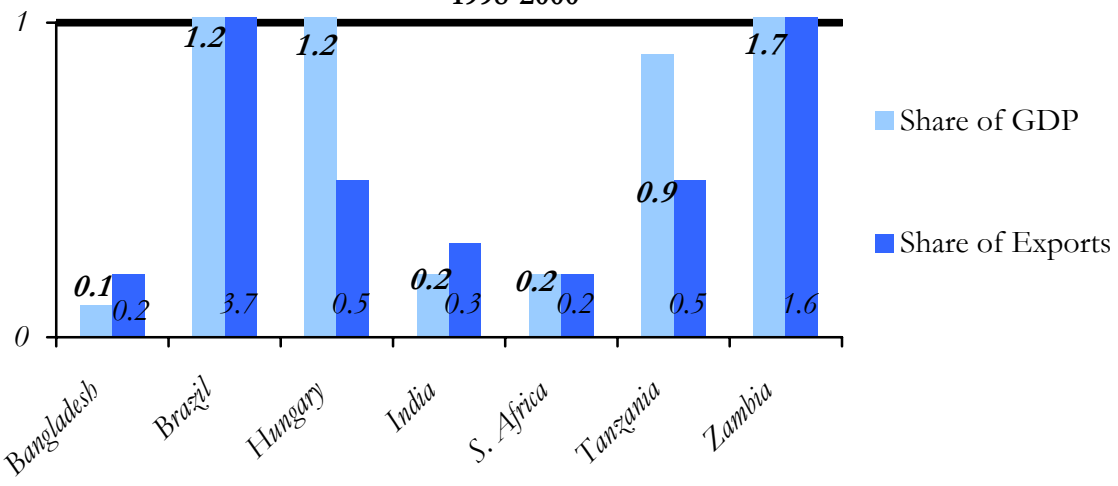
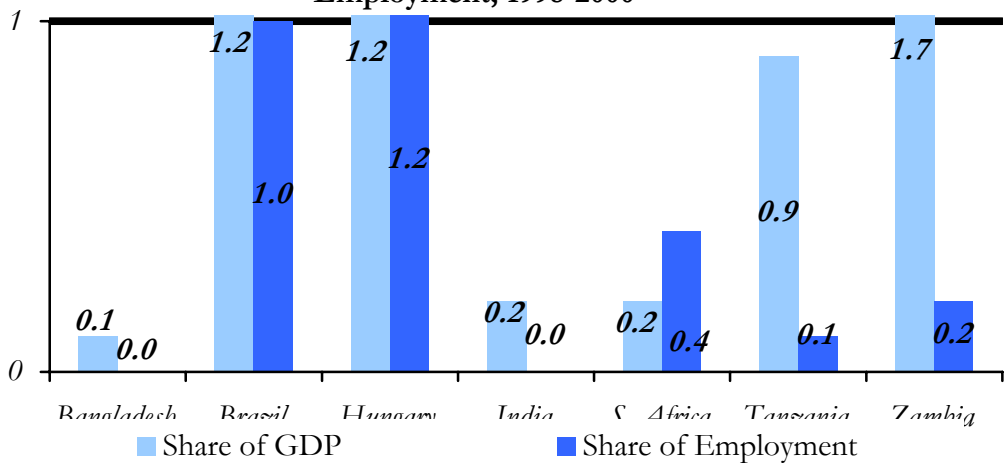


**Figure 19: Share of World FDI to Share of GDP and Share of Exports, 1998-2000**




As has been mentioned earlier, these ratios can be affected by the size of the economy; but what these shares do reveal is that for their share of World GDP, exports and employment, FDI levels have been high in Brazil, Hungary, and Zambia. Therefore, relative to their size of the economy, FDI has been high. But what it implies for further FDI is discussed in the next section.

**Figure 20: Share of World FDI to Share of GDP and Share of Employment, 1998-2000**




The key point is **that large capital inflows in short periods of time are bound to be followed by generation of profits that may be repatriated unless the economy is able to stimulate their reinvestment in the local economy**. Such trends affect the balance of payments situations even more adversely in conditions when inward FDI is stagnating and hidden profits transfers are taking place through payments for "business ad technical service payments". Both these conditions prevailed in Hungary. The data on Hungary showed that the outflows were more pronounced for

bank deposits and portfolio capital than for FDI that was less volatile. Even portfolio profit transfers were more pronounced than FDI related profit transfers. Thus, growing volumes of inward and outward capital/income transfer pose a potential threat to macro economic stability that may need to be actively corrected through macro-economic policy.

## The Civil Society Survey

For the purpose of this study questionnaires were sent to potential respondents from a range of organizations such as: Trade Unions, Business Associations, NGOs, religious organizations and representatives of the academia and the media. The respondents were asked to provide their perception on a number of issues related to FDI policy and performance. Between 30 to 50 respondents from civil society institutions have been surveyed for each of the seven countries on various aspects of FDI. The civil society survey was intended to obtain the views/perceptions of the civil society on a number of issues pertaining to FDI. The results of the survey are presented in the sections that follow below.

### 2.1 Comparison of results of civil society surveys

The queries were such that both positive and negative perceptions towards FDI were covered. Overall we find that in all the countries, civil society is significantly positively oriented towards FDI. More importantly, a comparison with the country experiences shows that civil society is highly aware of their own countries experiences. Countries that have had a positive experience in certain aspects show high agreement levels. Take for instance FDI enhances exports. The FDI in India is less oriented towards exports and more towards servicing the domestic markets (see Report A and B for India). Consequently, less than half the civil society respondents from India are in agreement. FDI into South African has also not had a negative impact on imports, and this is reflected in the low agreement for that query as well.

**Table 2.1: Positive Civil Society Perceptions**
**Percentage of respondents in agreement**

| | Bang-ladesh | Hung-ary | India | Tanz-ania | Brazil | South Africa | Zam-bia |
|---|---|---|---|---|---|---|---|
| FDI brings in valuable new management techniques | 84 | 90 | 89 | 70 | 100 | 100 | |
| FDI is a valuable source of foreign capital | 82 | 60 | 89 | 80 | 100 | 100 | |
| FDI brings in valuable new technologies | 88 | 92 | 82 | 92 | 82 | 96 | |
| FDI increases access to world market | 85 | 82 | 61 | 76 | 55 | 100 | |
| FDI increases the competitiveness of national economy | 85 | 90 | 79 | 73 | 73 | 100 | |
| FDI helps to enhance export | 76 | 72 | 47 | 76 | 64 | 100 | |
| FDI makes up for insufficient domestic investment | 68 | 80 | 56 | 48 | 45 | 88 | |
| FDI helps to reduce import | 58 | 53 | 34 | 41 | 45 | 65 | |

Overall, in all the countries studied, the import reduction impact is not considered to be an important one. In all the countries under consideration, it shows up as the one factor with which the least proportion is in agreement. International evidence on import reduction and FDI is also lacking.

As evidence and theory both have shown, technology and capital are the key contributions of FDI. Civil society perceptions are in line with these. However, there is less agreement on its other potential advantages such as making up for lack of domestic investment, competitiveness, and access to world markets.

Civil society in South Africa is the most in agreement with the positive aspects of FDI. Significantly, civil society in Brazil and India tends to have lower agreement with the positive aspects. Both Brazil and India are large markets with a strong domestic manufacturing base. The marginal impact of FDI on the factors queried would therefore be lower. We also find that civil society in Tanzania responds in a manner similar to Brazil and India.

The table below reports the perceptions regarding some potential negative aspects of FDI. It finds that overall, civil society in all the countries tends to not agree with the negative aspects. However there are significant inter-country differences.

**Table 2.2: Negative Civil Society Perceptions**
**Percentage of respondents in agreement**

| | Bang-ladesh | Hungary | India | Tanzania | Brazil | South Africa | Zambia |
|---|---|---|---|---|---|---|---|
| FDI brings in environment-ally harmful technologies | 38 | 28 | 39 | 38 | 18 | 23 | |
| FDI reduces the profitable opportunities available to domestic investors | 47 | 60 | 33 | 50 | 45 | 27 | |
| Foreign investors are only interested in getting access to domestic market | 58 | 46 | 72 | 47 | 55 | 23 | |
| FDI results out of unfair advantages of multinational firms | 65 | 58 | 38 | 45 | 27 | 31 | |
| Foreign investors do not care about impact of their investments on civil society | 62 | 56 | 45 | 57 | 45 | 23 | |

As may be expected, civil society in general perceives that foreign investors do not care about their impact on civil society. This is however, less so in the case of India, and Brazil. There is no agreement with this from the South African civil society respondents. South Asian civil society also largely agrees with the perception that investors are 'only' interested in gaining access to domestic markets. However, most respondents from other countries do not agree with this view.

The experiences of Hungary and to a lesser extent Tanzania also may have contributed to the responses from these two countries which show that most consider FDI to negatively affect domestic investors. Overall, the responses suggest that negative perceptions are the least in South Africa, followed by Brazil. For the rest these negative perceptions have persisted.

Overall therefore the civil society is strongly in agreement with the positive aspects of FDI. However, there is significant concern related to the negative aspects in most countries. Given these concerns it is but natural that respondents would have views on the role that the government should

play. Many queries related to the direction that government policy should take were asked. The responses are reported and discussed below.

**Table 2.3: Policies to increase the benefits of FDI – Percent responding 'Yes'…1**

| | Bang-ladesh | Hungary | India | Tanzania | Brazil | South Africa | Zambia |
|---|---|---|---|---|---|---|---|
| Support local businesses to upgrade technology/gain access to finance, etc. | 91 | 84 | 86 | 98 | 100 | 100 | |
| Strengthen environmental regulation | 77 | 88 | 81 | 93 | 0 | 54 | |
| Introduce/strengthen competition policy | 89 | 64 | 83 | 100 | 67 | 65 | |
| Strengthen sectoral regulation | 66 | 58 | 83 | 97 | 17 | 38 | |
| Strengthen labour legislation | 69 | 40 | 76 | 98 | 17 | 4 | |
| Strengthen intellectual property rights legislation | 88 | 63 | 95 | 90 | 33 | 69 | |

Apart from Tanzania, in all the countries there is strong agreement with the potential policy action that would support the strengthening of domestic businesses. There is less agreement on the necessity of strengthening environment regulations – Tanzanian, Brazilian and South African civil society is not as much in support of this measure. This could also be the result of strong environmental regulations already in place in countries such as Brazil.

As has been discussed in other parts of this study, the gains from FDI can be the most significant when there is a high level of competition. Competition prevents FDI from extracting monopoly rents and repatriating them. Another aspect of competition is that counter-balancing forces are present in the economy that could prevent exploitation. Strengthening of competition policy gets among the largest affirmative responses in all countries.

Civil society from countries that have had among the highest FDI historically also tends to be less oriented towards greater regulation and legislations. Responses from South Africa, Brazil, and Tanzania, all show lower agreement for greater government intervention than other countries.

**Table 2.4: Policies to increase the benefits of FDI – Percent responding 'Yes'…2**

| | Bang-ladesh | Hungary | India | Tanzania | Brazil | South Africa | Zambia |
|---|---|---|---|---|---|---|---|
| Impose requirements on firms to: | | | | | | | |
| ▪ Create jobs | 84 | 84 | 89 | 95 | | 46 | |
| ▪ Employ local managers | 80 | 54 | 75 | 97 | | 62 | |
| ▪ Transfer technology | 91 | 82 | 86 | 94 | | 73 | |
| ▪ Source supplies from local firms or impose local content norms | 71 | 78 | 68 | 94 | | 38 | |
| ▪ Export from the economy | 80 | 53 | 85 | 94 | | 46 | |
| ▪ Balance foreign exchange impact | 62 | 38 | 47 | 88 | | 12 | |
| ▪ Transfer skills and know-how to local subsidiary firms | 94 | 88 | 80 | 100 | | 69 | |
| ▪ Transfer skills and know- | 63 | 62 | 67 | 81 | | 38 | |

| | Bang-ladesh | Hungary | India | Tanzania | Brazil | South Africa | Zambia |
|---|---|---|---|---|---|---|---|
| how to local non-affiliate firms | | | | | | | |
| ▪ Train local technical and managerial manpower | 94 | 92 | 87 | 97 | | 100 | |

Generally civil society is highly in favour of imposing certain requirements on FDI. This again indicates that though FDI is considered to be positive, there is a strong perception that specific government regulations and requirements can have a positive impact. Of the countries studied, The Tanzanian and Indian civil society is the most in favour of specific government interventions. Curiously, South African civil society, that has strong positive orientation towards FDI also calls for many specific interventions and policy measures.

Employment and technology related requirements receive the most support in all the countries studied. Within these class of interventions, those related to the training of local employees receive the strongest support. Overall, civil society in India is the most in favour of greater government action to increase the net benefits of FDI to the economy. In Brazil the responses are more varying and are highly issue specific. Significantly, balancing requirements for foreign exchange outgo have the leaqst support.

In sum therefore, civil society responses reveal that there is a perception that foreign direct investment plays an important role in the development of host economies. There was a high degree of agreement in their assessment of the positive contribution FDI gave to the development of their countries.

## 2.2 Why civil society: A discussion

FDI is at the core of the internationalization of the domestic policy agendas of countries. The value of inward FDI to economic growth and development was fairly well recognized and that the unilateral liberalization of FDI policies and regulatory frameworks undertaken by developing countries was a clear recognition of this. A major objective of developing countries in seeking FDI should be that it makes a significant contribution to enhancing the efficiency and competitiveness of their economies. Moreover, FDI policy in developing countries will have to be formed on the basis of many development-oriented criteria. Governments of developing countries may see FDI as vital in promoting their economic development and supplementing domestic savings. But equally important is how policy could help countries to maximize the positive effects of FDI and minimize the negative effects.

Developing countries typically follow a dual approach in their FDI policy. On the one hand they increasingly welcome FDI, and on the other tend to put in place certain restrictions or constraints in their operations. This dual policy, it appears, has public support. That is, even the civil society respondents tend to welcome FDI they are also in favor of certain interventions that would prevent them from functioning in a completely free manner.

Moreover, given the heterogeneity in the levels of development of developing countries - and the asymmetry in their characteristics and economic conditions - objectives would tend to vary widely among developing countries. It is neither feasible nor desirable to formulate an inventory of development objectives that was applicable to all developing countries. At the same time, it is interesting to note that concerns related to FDI are broadly similar across a wide range of countries.

Globalization and interdependence have opened new opportunities. Some countries have successfully adapted to the changes and benefited from globalization, a contributory factor being their openness to FDI. But has openness to FDI actually helped the overall development of these countries or their 'integration' in a sustainable way into the global economy? In order to help developing countries to prevent and overcome any negative effect of economic globalization, there is a need for governments to form development policies, taking into account their own social, human and environmental dimensions. And the orientation and participation of civil society can play an extremely important role in the process. That is, maximizing the benefits of FDI requires sound domestic policies supported by an enabling environment. And this enabling environment will only come about if policies are in line with the views of civil society.

As has already been discussed, it is generally agreed that capital accumulation and technological capacity-building, along with equity considerations, form the basis of overall development. The nature of MNCs lies in their ability to bring capital, technology and organizational ability to developing countries, while their objectives of profit maximization may lead to the overexploitation of the host economies.

Unlike policy-makers, economists, and industry associations, civil society tends to look at many non-economic dimensions as well. Not just capital inflows, or technology improvements, or profitability. For any broad consensus to be achieved, countries need to take into consideration the views of the representatives of civil society. This is true for many reasons. But one of the key importances lies in their credibility and ability to affect long-term public opinion. Sustained and long-term improvements in FDI policy can be achieved if there is consensus among the general public. This consensus in turn can be more easily achieved if there is active support of civil society organizations.

There is a need for governments therefore to interact with civil society, and engage them in a dialogue in a constructive, structured and organized way. Civil society therefore should be involved in the decision-making and monitoring processes on FDI on the international and national levels.

The respondents across all countries tend to perceive that the positive impacts are many.

- FDI improves the access to new technologies
- It brings in new management techniques
- Tends to increase the competitiveness
- Is an important source of foreign capital.

In other words, civil society tends to support greater FDI into their countries. Moreover, civil society in most countries studied also tends to have low negative perceptions related to FDI. Policies related to attracting FDI therefore can be expected to receive general supported.

At the same time other perceptions are not as positively oriented towards FDI:

- There is less agreement regarding the contribution to increase business opportunities for local companies.

- There is also less agreement related to increases in exports and reduction in imports.
- Civil society also believes that international investors are less concerned about issues such as environment or importance of civil society itself
- It also tends to believe that specific policy measures can have a positive impact on the net benefits of FDI.

If policy follows views of the public, which in turn are affected by civil society, then it should be expected that specific interventions in the functioning of FDI related firms will exist. It is however not clear whether such policies are beneficial in the long run. Civil society in the countries studied certainly thinks so.

## Insights from case studies

The seven countries studied each have different sectors that have been at the forefront of the policy and FDI related changes in recent years. Some of these sectors such as software in India, textiles in Bangladesh, automobiles in Brazil, mining in Zambia and Tanzania, food and beverages in South Africa are important sectors in their own right. They may significantly contribute to overall employment and output, or export earnings. Moreover, significant changes in the international economic scenario as well as other factors not under the control of the governments have provided opportunities for further expansion.

Governments have followed up on the increased opportunities as well. Increased globalization brings with it the possibility of greater production (to meet international demand), investment (by way of FDI for one), greater exports (access to international networks), etc. Countries such as Tanzania have liberalized their mining sector, such as India have made it easier to invest in their software sector, Bangladesh's textile industry has been a singular success in the nineties.

On the other hand, cases such as Cement in Bangladesh and Power in India reflect how policy that is not in line with efficiency and economic considerations can lead to a situation where not only are the requirements of cheap and quality products not met, but overall investment also suffers.

Two large sectors, automobiles and telecommunications have seen large changes in recent years. In the case of telecom the opportunities provided by technical changes provides large opportunities that would benefit consumers as well as overall economy. In the case of automobiles the international restructuring activity (largely through mergers and acquisitions) has had a significant impact on efficiency and scale of MNC operations in host countries.

Each of the cases studies the background, the policy, the structure of the industry, and the role that FDI is playing or has played in the sector. The range of sectors and countries yield a rich set of insights into what has worked and what its impact has been on the economy.

The sectors include auto, power, mining, telecom, textiles, cement, and also include services such as the financial and tourism sectors. Generally the sector that received the highest FDI flows, either actual or approved, was chosen. Sectors were also chosen on the basis of current and expected

future importance for the particular country's economy by the partner organizations.[5] Automobile and telecom make up the main comparative studies because the most number of countries have chosen these, which reflect the importance of these sectors in the FDI picture in the project countries.

This section first summarizes the case studies across those sectors where some comparative insights can be drawn – Automobiles and Telecom followed by Power, Mining, and Processed Foods. It then draws insights from the commonalities and differences in the experience of different countries in these segments. Next the section takes up individual cases – those for which we cannot compare across countries – for summarizing the key issues. It draws important policy conclusions and insights from these cases. The idea is not to report in detail what has occurred or is occurring (for that the reader is referred to the specific country paper), but what overall lessons can be drawn. However, a brief for each case is given.

## 3.1 The Automobile Sector

### India

The Indian auto industry encompasses commercial vehicles, multi-utility vehicles, passenger cars, two wheelers, three wheelers, tractors and auto components. There are in place 15 manufacturers of cars and multi utility vehicles, 9 of commercial vehicles, 14 of Two/Three Wheelers and 10 of Tractors besides 5 of engines. India manufactures about 38,00,000 2-wheelers, 5,70,000 passenger cars, 1,25,000 multi utility vehicles, 1,70,000 commercial vehicles and 2,60,000 tractors annually. It ranks second in the production of two wheelers and fifth in commercial vehicles in the world.

Since delicensing in 1991, the automobile industry including auto component sectors has shown great advances. The contribution of the automotive industry to GDP has risen from 2.77% of GDP in 1992-93 to current value of 4% of the GDP. It contributes about 17% 0f the indirect tax revenue. The turnover of the automobile sectors has jumped nearly three times from $ 3646 million in 1993-94 to $ 10463.8 million in 1999-2000. Exports have also increased sharply between the years, more so in the case of ancillary units. These sectors have been performing well as indicated by rising ratios of retained profits/total sources of funding. Both these automobile related sectors have attracted large FDI flow; as a result of which capital employed in the automobile industry (auto component sectors) has risen from $ 1554 million in 1993-94 to $ 5384.4 million in 1999-00.

The entry of new firms in the automobile industry has led to reduction in the market concentration across a range of sub-sectors. This has to a large extent been the result of policy changes. In the past the policy was more interventionist; it called for:

1. Establishing actual production of cars and not merely assemble vehicles;
2. Minimum foreign equity of US $ 50 millions must for joint venture involving majority foreign equity ownership;

[5] In other words, the choice of the sector was based on available information, an interactive process between CUTS and the country team, as well as perceptions of the country experts.

3. Indigenise components up to a minimum of 50% in the third and 70% in the fifth year or earlier from the date of clearance of the first lot of imports.
4. Neutralize foreign exchange outgo on imports (CIF) by export of cars, auto components etc. (FOB).

The new automobile policy however does not prescribe any minimum investment norms. As part of the policy, the Government has promised to give adequate accommodation to indigenous industry in respect of items such as buses, trucks, tractors, completely built units and auto components, which have bound rates under the World Trade Organization guidelines. In respect of items such as cars, utility vehicles, motorcycles, mopeds, scooters and auto rickshaws (which do not have a bound rate), the new policy proposes to design import tariff "so as to give maximum fillip to manufacturing in the country without extending undue protection to the domestic industry."

***In sum therefore, the large potential Indian market was being underserved as it was not feasible for foreign firms with the required capital and technology to service the market with a free hand. With the opening of the sector towards FDI along with greater liberalization of the external trade sector, the supply constraints vanished leading to high growth in output and by extension on employment.***

**Brazil**

The Brazilian automobile sector has gone through a deep process of productive restructuring, which made it much more efficient and competitive, as can also be shown by investments made on both new and old industrial plants; launching of new products; implementation of new forms of organizing the productive chain; and by productivity gains, among others.

The increase in domestic demand and production in the period 1993-97, benefited by a process of economic stability and by the automotive regime, created an opportunity for a considerable volume of investments made by already established carmakers, initially aiming at modernizing products and productive processes, and, later, followed by new companies (newcomers), aiming at creating and/or expanding the productive capacity of vehicles and components.

The sector's restructuring has promoted significant labor productivity gains, explained, on the one hand, by the modernization of plants and, on the other, by the new productive and organizational processes adopted, which have increasingly transferred assembly line activities to suppliers, besides subcontracting support activities. Mergers and acquisitions prevailed, following international trends. Only part of the investments represents an increase in productive capacity, the rest being mere transfers of funds to the incumbent owners. Besides, mergers and acquisitions promoted an intense process of concentration and denationalization in the sector.

Within the process of reorganization, construction of new units, and mergers and acquisitions, FDI played a decisive role. The sector of auto-vehicles was one of the greatest receptors of FDI in the manufacturing industry, accumulating more than US$ 18.6 billions in investments between 1995 and 2000, about 23% of the total channeled into the industry in the same period. Much of the new capacity has been due to FDI from established international players. These are reported below.

**Table 3.1: New Industrial Plants constructed since 1996**

| Enterprise |
|---|
| Chrysler |
| Daimler Chrysler |
| Fiat |
| Ford |
| General Motors |
| Honda |
| Iveco Fiat |
| MMC Automotores (Mitsubishi) |
| Nissan |
| Peugeot Citroën |
| Renault |
| Toyota |
| Volkswagen Audi |
| Volvo |

It is well received wisdom that investments made reduced the competitive gap between Brazil and developed economies not only with regard to products but also productive facilities and processes. The incumbents gained as well. Investments made and strategies adopted by already established carmakers had as common goals:

a) Expanding production capacity and updating models;
b) Specializing the production of small cars (compact cars) to obtain economy of scale, which allows carmakers to work with efficient scales, according to international parameters;
c) Differentiating products for basic compact models, which gave origin to other versions of compact cars, more sophisticated, with more potent engines and several optional items;
d) Complementary productive structures and product lines between Argentina and Brazil, promoting an intense trade flow intra-Mercosur. Thus, carmakers could increase the variety of supply and promote market segmentation without losing economies of scale.

***In sum, the international automobile re-alignment that has been going on through the late eighties and continues till date, has also had significant benefits for the Brazilian industry that has historically been open to international investors. Restructuring has reached Brazil with a time lag, but has led to greater competitiveness, growth of capacity, and by extension greater competitive strengths and growth. Somewhat different than the case of India, Brazil's experience shows that if given a relatively free hand (not prevented by many rules and regulations) greater openness generates its own 'pull' for greater FDI, thereby benefiting all.***

**Hungary and its Car Industry**

Hungary was one of the first among the transition economies to set up its own Car manufacturing industry in the early 1990. Prior to that though Hungary had experience in the production of road vehicles (buses and light trucks), no car production was present. Based on local skills a new industry was established within 4-5 years that was able to spread to different categories of the market from low-cost popular lower middle class models (Suzuki Swift) to luxury roadsters (Audi TT), and from main part production (GM and Audi engines and transmissions) to assembly of finished products (Suzuki, Audi). Additionally, a large number of supplier companies also settled in Hungary, thus, the majority of the supplier chain also produces in close locations (Loranger, Knorr Bremse, Bendix, Bosch, etc.). Assembled cars, as well as parts of vehicles became the most important items in both Hungarian exports and imports. All this restructuring was carried out through FDI, that made good use of the fiscal incentives of the Hungarian governments and the available relatively cheap, experienced skilled labor force. FDI has been the oprimary determinant behind the inception and expansion of the industry. Japanese, American and European firms are present in the country today.

As in some other countries this large automotive sector depends predominantly on the international suppliers of the international automakers, some of whom have set up a manufacturing base in the country as well. Because of EU local content rules Japanese carmaker Suzuki did very important efforts at recruiting and training Hungarian suppliers to meet international demand standards, but few Hungarian companies could develop the required skill/quality base.

Almost all the car firms started with a smaller, experimental investment and continued investing thus expanding activities. In this sector it was rather the picking-up of upstream activities that determined the direction of expansion. GMs Opel division for example stopped the low-scale assembly, and concentrated on engine production instead. Also, other subassemblies were introduced into production. Many firms went further, and opened new corporate functions, not just new production lines. There were examples of R & D activity, carried out in Hungary, and some companies established cooperation links to various technical universities in the country. Thus, overall spillover effects may be quite promising, despite of the fairly weak business cooperation with local firms.

***The Hungarian example suggests that spillovers should not only be seen from the perspective of locally owned firms but for the economy in general. The low ownership base of Hungarian engineering and auto ancillaries has perhaps reduced spillover effects to the rest of the economy, however the need for generating surpluses has also motivated international firms to look at other value generating activities such as R&D.***

**South Africa**

The SA motor industry is undergoing a radical process of change. As part of its plan to attract manufacturing investment, the government replaced its previous strategy to develop a local motor vehicle manufacturing industry with the 7-year Motor Industry Development Programme (MIDP) in 1995. Previous strategies to develop the domestic industry were premised on local content requirements and high tariffs on imports. Although this policy was effective in leading to the establishment of a significant assembly industry, encouraged into 'partnership' with a diversified domestic component sector, most producers were not internationally competitive.

The MIDP has five principal objectives:

- Improve the international competitiveness of OEMs and automotive component firms.
- Improve vehicle affordability in real terms.
- Enhance the growth of the assembly and components industries, particularly through exporting.
- Improve the industry's trade balance.
- Stabilise employment levels.

Today, the automotive industry is one of SA's largest employers. Vehicle manufacturers alone collectively employ more than 32,000 and the total number employed in the motor industry in SA – including assembly, component manufacturing, the tyre industry and the motor trade – exceeds 250,000. There have however been several job losses over the past few years, notably in the assembly and component industries

SA original equipment manufacturers (OEMs, the name given to assemblers or makers of cars) are part of a worldwide network, as are some of the component suppliers. SA has 8 light vehicle producers and 11 medium and heavy vehicle producers.

**Table 3.2: Vehicle Producers in South Africa**

| |
|---|
| BMW SA; |
| DaimerChrysler SA; |
| Delta Motor Corporation; |
| ERF SA; |
| Fiat Auto SA; |
| Ford Motor Company of Southern Africa (previously the SA Motor Corporation); |
| IVECO SA; |
| Man Truck & Bus SA; |
| Nissan SA; |
| Renault Export Ltd; |
| Scania SA; |
| Toyota SA; |
| Tyco Truck Manufacturers; |
| Volkswagen SA; and |
| Volvo Southern Africa. |

According to the case study, FDI in this sector appears to have had:

- a positive impact on technology transfer (the availability of new technologies, demonstration of better technologies to local firms, and learning and technology up gradation by local firms);
- increased competition in the market;
- an improvement in the quality and choice range of products available to consumers; and
- a positive impact SA's balance of payments.

Successful foreign involvement to date has centered around partnerships to produce locally for export. The major component exporters are firms linked to OEMs, foreign-owned firms and larger domestic groups.

However the competitive pressures combined with restructuring has had a negative impact on employment in recent years. This however cannot be ascribed solely to FDI. Lower tariffs have forced some of the more uncompetitive producers to close. Several local component-manufacturing companies for instance have closed.

Moreover, concerns have also come up that transfer pricing methods may be depriving the South African economy. To regulate transfer pricing, SA's customs officials and other relevant authorities require skills and resources to share information internally and among national regulators to detect unfair transfer pricing.

***South Africa's experience shows that though benefits are realized they do come with some costs. Theory predicts that these costs such as job losses are only in the short term and micro; the macro gains are more sustained and have positioned the South African industry on a stronger footing. However, transfer pricing issues are an international reality. Even developed countries have had difficulty in regulating these aspects of modern MNC functioning. It is difficult to see how control over such practices can be exercised by governments.***

**The Automobile Sector – A summary**

The four cases studied all have one thing in common, the expansion in production and growth in competitiveness of the domestic industry. In the case of India, which had historically been less open than Brazil or South Africa, the growth has been largely due to removal of supply constraints. In the case of Brazil the improvements have been aided by the wider international re-organization of the automobile industry. This has shown up with a time lag but has benefited Brazilian industry nevertheless. South Africa's experience also shows that importance that mergers and acquisitions are playing in recent years. In the case of Hungary however a differentiation will have to be made between domestic industries and domestically *owned* industry. A weak base of domestic owned firms notwithstanding the domestic industry (predominantly MNC owned) has gained. Moreover, gains in competitiveness have made the future potential of the sector stronger in all the countries studied.

In all countries, there has been significant movement away from past policies. In all three, the government has been increasingly playing a less interventionist role. This has likely been the direct cause of the recent changes.

The automobile sector is highly integrated internationally, with production of components occurring in more than one country, automobiles produced in another, R&D occurring in still others and so forth. However, the automobile industry is also highly concentrated within a few quasi-groups. Suppliers to one large manufacturer in one country also tend to be suppliers in other countries, depending upon market conditions this may be through international trade or through FDI. In all the countries, we find that these international 'quasi-groups' play a significant role. This high degree of international integration brings with its its own set of risks and opportunities.

The problem of transfer pricing is one such risk. Given the nature of the auto industry and international networks of firms and their suppliers, the potential for transferring profits between countries and circumventing the tax regimes in host countries, is a reality that few can or should ignore. Another characteristic that goes with international networks of firms is that positive (or negative) shocks in a country far away can directly impact production in another. Whether host countries should take this into consideration in policy formulation is an open question.

## 3.2 The Telecommunication Sector

### South Africa

This sector contributes more than 7 per cent to SA's GDP. By 1999 telecommunications was the top earner in FDI (due to the 1997 Telkom deal). In 2000 telecom and IT was ranked fourth in terms of investment inflows for that year, recording R2.404 billion (U$204.7 million).

The sector is currently undergoing 'managed liberalization'. One of the key components of this liberalization is the movement away from monopoly (Telkom) towards greater competition. The importance that the government ascribes to this sector is clearly seen in the functioning of the International Task Force on Information Society and Development that advises the government on how to attract investment and create sustainable development in the communications and IT sectors.

The end of Telkom's exclusivity period means that a second network operator (SNO) will now be licensed (thus creating a duopoly, before full liberalization). Telkom however will still enjoy monopoly status until the SNO is licensed and can begin operations. This therefore ensures that market entry for the second operator even more difficult. The new operator will be predominantly owned by local and international private sector bidders, but also part owned by state-owned companies and also by a black empowerment company.

SA is the fourth fastest-growing Global Systems for Mobile Communications (GSM) market in the world and is growing at a rate of 50 per cent per annum. By December 2000 there were 7.7 million cellular users in the country. One study estimates that there may be as many as 21 million cellular phones in SA by 2006 (GCIS, 2001:117). Six consortium bids for the third cellular licence (awarded in 2001) are indicative of a healthy interest in SA as an investment location for telecoms. Three cellular network operators, two established in 1994 and the third in 2001:

- Vodacom: Vodacom is SA's leading cellular network with a 60 per cent share of the local market. Telkom is the majority shareholder, with 50 per cent equity; the other prominent investor is the UK's Vodafone, with 31.5 per cent share of the company.
- MTN: MTN is Africa's largest cellular operator and has won licences to operate in Cameroon, Uganda, Rwanda, Swaziland, and most recently, Nigeria.

- Cell C: Cell C was awarded SA's third mobile operator's licence in June 2001 after a one-year delay. Cell C is backed by Saudi Oger. It also brings in Verizon Communications, the biggest cellular operator in the US.

The countries that currently have the strongest presence in the SA telecom industry are Germany, France, the Netherlands, the UK, the US and Malaysia. These countries hold a dominant position in the local market through their TNCs which include established international players.

| **Table 3.3: Foreign firms in South Africa** |
|---|
| Siemens |
| Alcatel. |
| Phillips |
| Vodafone |
| Oger |
| Thintana Communications |

***In sum, growth in the telecom sector has been a result of exogenous factors such as significant improvements in technology (the emergence of cellular phones). It has also been supplemented by more liberal government policy. However, it is apparent that putting on other policy objectives such as black empowerment, will only delay the reform process. This delay not only affects greater competition and poor choice to consumers, it is also a significant opportunity loss to the economy. Despite these problems however, it is likely that the telecommunications sector will boom in the long run provided the government keeps its policy direction intact.***

**Brazil**

The tele-equipment sector went through a deep restructuring process in the last decade. The privatization of Telebras system (State owned telecommunication companies) generated a wave of investments from operators aiming at accomplishing the goals established. The potential growth of the sector fostered foreign investments in the form of both mergers and acquisitions and new plants. Thus, three characteristic of the telecommunications industry in the last decade are:

a) Increase of productive capacity with a large number of investments in the sector;
b) Strong movement of acquisition of domestic capital companies by foreign companies and intensification of mergers;
c) Preservation of the industry's profitability indicators at positive average levels.

More recent data confirm a predominance of foreign companies, thus increasing the degree of internationalization of the industry in Brazil. In 2000, out of the 42 main companies in the sector, 26 were foreign and 16 were domestic capital companies. However, regarding sales, the foreign represented 91.3 % of total sales against 8.7% in the case of domestic.

The evolution of the sector's external trade in selected years shows large expansion of imports from 1989 to 1997, year in which the privatization of telephony operators was under way. From about US$ 226 millions, imports jumped to US$ 3 billions, growing again in 2000 and 2001, even after currency devaluations.

The telecom services and manufacturing industry comprises of high volumes of FDI corresponding to about 2.5% of total FDI. As mentioned before, great part of investments were attracted by incentive policies and mechanisms. In general, these policies do not make any distinction between domestic and foreign companies. The main policies are the Information Technology Act (Lei de Informática), the Program of Support for Investments on Telecommunications (Programa de Apoio aos Investimentos em Telecomunicações-PAIT) and the Fund for Technology Development (Fundo de Desenvolvimento Tecnológico-FUNTEL).

The new act has maintained measures of two natures for the sector: on the one hand, it determines criteria for public purchase of goods and services and, on the other, criteria of encouragement to technological improvements and local production. The act seeks to prioritize the production of domestic goods and services, as long as they are similar to the foreign in quality, standards, compatibility and performance. In addition PAIT program provides credit lines for manufacturers of tele-equipment and operators that aim at strengthening local production and exports.

In sum the expansion of infrastructure boosted demand for final goods, and the latter, in its turn, boosted the demand for intermediary goods. Telecom equipment industry has become highly internationally owned, the main manufacturers adopt outsourcing policies of global character, with a high volumes of imports. Probably as a result the domestic productive basis of parts and components has reduced its dimensions, causing an increase in imports in this sector. The government has meanwhile come up with policies to support domestic manufacturing base; however it is too soon to tell whether they will bear fruit.

***Given the nature of the telecom industry, its recent technical advances, and increased openness, the growth is not surprising. However, it has had a negative impact on the domestic manufacturing base of the uncompetitive sectors. Imports of intermediaries being the primary gainer. The Brazilian case reflects one of impact of greater FDI and openness – the loss of uncompetitive domestic base. Whether this impact is negative at the macro-level is not possible for us to judge. However, all available evidence would support the view that economies are better served if reallocation of productive capacity towards more productive sectors occurs.***

**Hungary and Basic Telephony**

The turning point in Hungarian telecom sector lies from the privatization of the Hungarian Telecommunication Company (MATÁV). The stated objectives were threefold: The first was the definite necessity of mass scale capital investments to produce quite quick and far reaching technology improvement. The second was that effective market regulation was crucial in triggering the beneficial effects for customers. The third, that creating competition on monopolistic markets is not only a question of market regulation, it also requires companies willing and able to compete.

A few years prior to privatization, the imperatives of network development led MATÁV to launch the establishment of the nationwide fiber-optic network. However, due to low supplier

and in-house efficiency levels, MATÁV was unable to finish this large project. This in turn catalyzed the decision to privatize. The privatization deal was based on three pillars.

- Adequate level of budget revenue for the state,
- Adequate extra capital inflow from the buyer to finance the network expansion investments, and
- Agreement on market regulation that maintained monopoly for interregional and international calls, but contained regulations for access rights and other necessary multi-player market regulations, as well as a price cap system, aimed at controlling price developments.

Deutsche Telecom principally met the three conditions in its bid, and the deal was concluded.

The nationwide network was completed, regional exchange centers were created, the overall density of telephony increased according to fixed in the privatization agreement to more than three times within a few years, and the quality of the services improved. Prices did not fall below those in other countries, though long distance calls' prices fell gradually. Local calls as well as subscription fees did not decline. This was in fact the "price" paid to DT to invest in Hungary. Most subscribers admit to have enjoyed the tremendous improvements in quality.

The nuclei of potential competitors were already in the system: three different multinational consortia got access to local services provider status. And when the state granted monopoly expired two more new nationwide suppliers entered the market. However, their impact remained minor at least after one-year of operation. They tend to concentrate on "cash cow" businesses (such as commercial subscribers) and tend to have avoided the less profitable individual subscribers' market.

Competition has also come in from another direction. Cellular telephony developed deep roots in Hungary. Starting only in 1995 by 1998 the then two providers achieved the same number of subscribers as MATÁV with fixed lines. The most recent figures indicated over 8 million subscribers for mobile services (the number of service providers increased to three in the meantime), this all at a total population of just 10 million inhabitants! At the same time, the number of MATÁV subscribers started to decline from its 2.3 million peak to 2 million.

***The Basic Telephony instance from Hungary reveals some very interesting insights. First, MNCs can make great successes out of inefficiently run public sector firms. Second, it is difficult for other large players to complete against the privatized MNC, this is because the incumbency factor combined with the operational and financial strengths are extremely powerful combinations. Third, however technical changes have the power to overturn any established firms. The mobile phone sector has succeeded in extremely high penetration levels and has perhaps affected the growth prospects.***

**Tanzania**

In 1978 Tanzania Posts and Telecommunications Corporation (TPTC) was formed to take over the powers and functions of the defunct East African Posts and Telecommunications Corporation. As

of 1991, there were 188 telephone exchanges with a total capacity of 104,460 lines with 78,000 lines connected which was about 85 percent capacity utilization. The telephone density in the country averaged 0.3 lines per 100 population compared to the average of 0.46 per 100 of population in Sub Saharan Africa. The quality of service was poor; workers productivity was low, while demand was as high as 200 percent of supply. Local tariffs were very low (equivalent of US$ 0.02 per minute) while international tariffs were among the highest in the world.

Tanzania is currently in the process of modernizing its telecommunications sector. The government started to focus on liberalization of its telecommunication industry in 1993 through the implementation of the Telecommunications Restructuring Programme (TRP). The net result of TRP was the separation of TPTC's posts and Telecommunications activities, and the establishment of the Tanzania Communications Commission (TCC) in 1994. The government allowed private sector participation in provision of non-basic services such as value added services, specialized services such as mobile cellular telephone, sale and installation of customer premises equipment (telephone sets, fax, telex etc.), and in wiring subscriber premises.

Tanzania's teledensity has since improved to 0.8 per 100 persons as of February 2002. While this is still too low compared to that of developed countries and the sub Saharan Africa, it is nevertheless, a good reflection of the improvement in telecommunications infrastructure.

One of the explicit goals of liberalization and privatisation in telecommunications sector in Tanzania was to attract foreign direct investment which would bring with it skills and technology. International participation in Tanzanian telecommunications sector is high and has ranged from operation of the networks to various value-added services such as data transmission. The growth of the telecommunications sector has also seen proliferation of foreign equipment suppliers in Tanzania, as shown in the table below.

| **Table 3.4: Foreign firms in the Telecom Sector** |
|---|
| *Cellular equipment and network infrastructure suppliers* |
| Alcatel |
| Motorola |
| Siemens |
| Ericson |
| Nokia etc. |
| Alcatel |
| *Fixed line infrastructure suppliers* |
| British Telecom TMC (UK) |
| Dial Face (Italy) |
| CROMPTON (India) |
| ERCA |
| DPA (South Africa) etc. |

The introduction of liberalization and competition in telecommunications has shown a positive driving effect on the adoption of new technologies, on the market development and more in general on the entire Tanzanian economy. There have also been faster rollouts of networks to achieve universal service objectives. For instance, the number of telephone lines installed grew from 76,369

in 1991 to 126,515 in 1999 and 177,802 in July 2001 with an exchange capacity of 234,640. This and the growth of the number of mobile telephone subscribers reflects the introduction of new and more efficient technologies as well as what competition have done in the sector.

***In sum, the Tanzanian case reflects the opportunities that capital constrained governments can exploit by allowing and attracting greater FDI. The large investments required can relatively easily be accessed when international firms are involved. This can significantly impact the provision of better and greater services to the consumers. Moreover, the Tanzanian case also shows that greater FDI in other complementary sectors such as equipment is better possible when the driving sector (the infrastuture/service sector) is allowed to grow unhindered.***

**Bangladesh**

Bangladesh is a country with one of the lowest tele-densities in the world. Until the early 1990's, the telecom sector in Bangladesh had been characterized by a traditional government owned monopoly for telecom services. Deregulation of telecommunications sector created scope for private operations to run mobile cellular phone systems, operate rural telephone exchange, provide paging and trunking facilities, and become Internet service providers. In the early 1990s a couple of private sector investors were licensed to provide rural telephone services, and one to provide value-added services like radio paging. A few years later, during the second half of 1990s, four private sector operators were licensed to provide cellular telephone services in the country. Many other private companies were licensed to become VSAT and Internet Service Providers (ISPs).

Inefficiency of BTTB, rent seeking activities by BBTB employees that increased cost of connection, inadequate growth of BTTB capacity resulting in a long waiting time for connection, convenience of cellular phone all resulted in a large pent up demand for mobile phones. Grameen Phone is leading in the mobile market with 73% market share. City Cell and AKTEL are closed with 12 percent and 11 per cent respective penetration followed by Sheba having 4 per cent of the market. While CityCell operates under ODMA technology, other three providers are GSM mobile operators.

A low interconnection regime has seriously hampered the country's mobile phone growth. More than 80 per cent of mobile users are not allowed to access the BTTB's local, national and international connection. The Ministry of Posts and Telecommunications (MOPT), the defacto regulator, not addressed the problem.

Private sector development of telecom sector, particularly in cellular phone services, is basically propelled by foreign investment. Foreign collaboration came from Malaysia and Norway. FDI inflows (including debt) in this sector have reached to US $50 million in 1997. Since then growth was even faster, foreign operators have invested in excess of US $ 250 million during last four years.

The impact of FDI in the telecom sector is quite evident. It has improved the communication network across the country. FDI, it appears, has played an important role in the telecom sector. It has brought in positive impact on quantity of jobs and quality of jobs. It also had positive impact on availability of new technology. FDI in this sector is also reported to have had a positive impact on quality and choice of products available to consumers.

***Bangladesh's experience shows how policies that do not allow the smooth functioning can directly harm consumers. Despite the observed advantages of FDI, foreign firms are not being provided a level playing field. In the process, greater capital inflows are also hampered. Telecommunications is one sector where FDI the world over has contributed significantly to better communications, integration of the people, greater investment in the economy, and better foreign exchange position. In Bangladesh however, the full potential has not been realized due to lack of interconnectivity. This lack of interconnectivity is essentially due to established players (public sector) having a say in policy formulation. And this has only harmed the country.***

**The Telecom Sector – A summary**

The five cases of Bangladesh, Brazil, Hungary, South Africa and Tanzania have certain commonalities. In all cases external influences (read technical improvements) in the international markets are being accessed rapidly by a rapid response of greater openness in FDI policy. This has had a positive impact on consumers in two ways:

- Greater accessibility of services
- Better quality of services

It is however not clear what the impact on prices has been. If cross-subsidization levels had been strong (as in the case of Tanzania) it is likely that price levels would have gone up in the sector. If however these were not, greater efficiency along with greater competition would have driven down the net prices availed of by the consumer. In any event, the economy has gained due to greater efficiencies and growth.

Another important factor deserves mention. Other complementary industries (such as equipment suppliers) can have differing impact across countries. In countries that had a internationally uncompetitive domestic industry, such as in Brazil, the short term impact would be negative. However, in countries where the domestic industry does not exist or is competitive the impact is likely to be positive.

A third factor has to do with net foreign exchange earnings. The telecom industry tends to be highly import-intensive, moreover, imports tend to be inelastic (as generally high technology items are). Consequently, it should be expected that imports would go up at-least in the initial stages. The case of Brazil shows that in the absence of a strong industrial base this may even continue for a long period.

Fourth large private telecom monopolies can lead to good outcomes for the consumers provided there is adequate competition and regulation (as in the case of Hungarian basic telephony). Even if

competition is not from within the industry, but from other sectors (such as cellular telephony) similar outcomes can be achieved.

Last, countries that do not load on other policy objectives tend to make faster progress in their telecom sector. Brazil has placed the objective of a strong domestic manufacturing sector in telecom as an important priority; high imports nevertheless continue. South Africa has placed policies related to black empowerment on potential new entrant. In the process, telecom sector is likely to be affected in the long run. Bangladesh has prevented interconnectivity perhaps in the belief that this would provide some advantages to government provision of services. Compare this with Tanzania, that has not loaded on other policy objectives. Note that this is not to criticize the other policy objectives, just that telecom policy should be more focused on what is likely to benefit the country the most – getting greater, better and cheaper services to the largest possible share of the population.

## 3.3 The Power Sector

### The Power Sector in India

Indian power system grew from a mere 1.7 thousand MW of installed capacity in 1950 to 100136 MW in 2000. However, as per the 1991 census, only 42% of the Indian households had electricity facility, with about 71% in the rural and 24% in the urban areas were not electrified. The central government has announced a series of policy measures to allow the participation of private power companies (domestic and foreign) in the power sector since the launching of the economic reforms in 1991.

Subsequently with a view to promote more investment in the power sector, government decided to permit 100% foreign equity for automatic approval for companies undertaking power projects including electricity generation, transmission, and distribution provided that foreign equity in any such projects does not exceed $ 300 million. The new policy also permitted 100% foreign owned companies to set up power projects and repatriate profits without any export obligations. Since private power companies have to sell their power to the financially weak state electricity boards (SEBs), there are concerns about regular payments. The government responded by agreeing to provide guarantees to foreign investors.

Despite these measures, the attempts to attract private investors have resulted in little success. The progress in terms of capacity build up has been minuscule. Thus, the Independent Power Producer (IPP) policy is broadly viewed as a flawed and half-hearted approach to reforms.

In the mid-90s, the World Bank played a major role in arguing for fundamental reforms of SEBs, and in persuading a few states- led by Orissa –to initiate reforms. However, the results have not been positive here as well. Since privatization, the new owners have brought neither new funds nor discernible management skills to the newly established companies. Revenues from privatization were not ploughed back into the sector, but absorbed into the government budget for other purposes.

The public has faced substantial tariff increases but has seen few benefits in service, which has led to growing political discontent with the reform process and a call to bring back the publicly owned system.

Between the years 1991 and January 2001, only about 4000 MW of capacity has been added by the private power projects. Out of these, there was only one mega project (Dabhol, developed by Enron, USA) involving foreign investment, which led to an addition of 740 MW of capacity (see Box D). The project soon started generating severe financial problems for the state of Maharashtra in western India. Maharashtra State Electricity Board (MSEB), which had been profitable in the 1998-1999, plunged into losses exceeding $300 million (excluding subsidies received from the state government) in 1999-2000. The Enron saga has definitely affected further FDI flows in the power sector.

***The power sector in India provides the classic example of what governments should not do. Attracting FDI requires the inherent conditions at the grassroots level to be profitable for the activity in question. First, the government did not make any changes at the grassroots. If in an environment even domestic investors are not likely to enter, providing extra incentives and expecting FDI to fill the gap is only going to lead to failure. Second, external institutions such as the World Bank can rarely be as well-informed about the ground realities as domestic industry professionals, hard policy decisions need to be taken with their insights.***

**Energy in Hungary**

The privatization and sale to foreigners of much of the Hungarian energy sector was not as successful as in the case of telecom privatization. The once monolithic energy sector was cut into pieces at the borders regional supplier networks and sold to different investors. Power stations were also sold, some of them together with some lignite mines that made their profitable utilization extremely difficult. International buyers somehow did not adequately foresee the impact of some of these high cost privatization deals.[6] In all likelihood the guarantee of 8 percent profits in setting prices colored their judgment. However, since then arguments and back and forth mar the smooth functioning of this sector. This is because the government is keen to reduce its price obligations, there is no incentive for the power suppliers to reduce costs, and moreover, some of their assets and production conditions do lead to increased costs.

However, on the positive side, international owners have largely fulfilled their investment obligations. The environmental impact of the power plants has also improved substantially; but employment in most of the mines could not be maintained.

The price control, as well as the state ownership of electricity transport networks provides an effective tool for the government to control trade with energy. The upcoming liberalization of the

[6] Coal mining has never been competitive with mines in Silezia, or even in the Ukraine generating much cheaper output than in Hungary. Though some firms may wish to import electricity rather than producing it locally, thus integrating Hungarian affiliates into their international network, market regulation does not yet allow an uncontrolled exchange of energy.

electricity market may change this situation. It is almost certain that then some of the currently operated power plants will be shut down.

***The Hungarian energy sector has had some improvements, however, greater efficiencies will be realized with even further liberalization. This would be at the cost of employment in the mining sector – whether the government can take such steps remains to be seen.***

**The Power Sector – A summary**

In both India as well as Hungary power sector reforms have been tentative; changes in the regulatory structure have also been attempted but have not reached an advance stage. Moreover, in both the countries, ground level relities were not taken into consideration at the time of FDI liberalization/privatization. As a result the full gains of liberlization and FDI entry have not been realized.

In both the countries, the pricing system is flawed. The promise of minimum returns is not possible for governments to fulfill in a sustained manner. IN the presence of ground level inefficiencies (high cost of fuel in Hungary and inability to extract revenues in India) have further contributed to the problems.

In other words, FDI entry might be possible with promises of minimum returns but is not sustainable in the presence of systemic inefficiencies. Liberalization, privatization, and better regulation have to go hand in hand with decisions that might be politically difficult but will be essential if FDI is to contribute to the maximum.

## 3.4 The Mining Sector

**Mining in Tanzania**

Between 1995 and 2001, the government embarked on rigorous efforts to foster policy and institutional changes that would enhance investment in mining. These efforts resulted in the formulation of the Mineral Policy of Tanzania introduced for the first time in 1997, followed later by enactment of a new Mining Act of 1998 (which repealed the Mining Act of 1979). The rules of the game for the sector were also set out in Mining Regulations, released in 1999.

The main objective of the 1997 policy was to facilitate the exploitation of mineral potentials that would contribute significantly towards income generation, employment creation, social and economic infrastructure development (particularly for rural areas), increasing foreign exchange earnings and government revenue as well as reducing poverty. Despite valid arguments for incentives for investment promotion there have been concerns that incentives have been too generous to the extent that the economic benefit of mining activities in Tanzania are reaped elsewhere rather than in Tanzania.

The sector has been growing at an average annual rate of 16.2 percent per year between 1997 and 2001. Its annual contribution to GDP rose from 1.7 percent in 1997 to 2.5 percent in 2001. Employment in the sector has also increased. Government revenue from the sector has also increased. The revenues from the sector are earned from taxes, prospecting royalties and mining license fees.

Local and/or joint venture and foreign direct investments have gradually increased in areas of exploration and mining. Large mining companies such as Ashanti Goldfields, Anglo gold, Barrick Gold Corporation, Resolute and others are currently involved in important mining projects in the country.

***The experience of the Mining industry in Tanzania reveals another set of insights into FDI policy. In the short run large incentives could attract FDI (provided ground-level conditions are right), however the overall long term benefits to the economy need to be considered before large incentives are provided. If such concerns remain and grow stronger, over a period of time governments will be forced to reverse policy. This could have a negative impact on long term development. Consequently, incentives should be given only if necessary and should not be too high for such policies to be politically unsustainable.***

**Mining in Zambia**

The mining sector has been a prime mover of economic development in Zambia for over 70 years, with exports of mineral products contributing about 70 per cent of total foreign exchange earnings. Over the years, the national economy has developed a comparative advantage in copper and cobalt mining. Deposits of gold, diamonds, zinc, gemstones, coal, and a variety of agro and industrial minerals are also found in Zambia. Large-scale mining is active in copper, cobalt, and coal while small –scale mining is active in a variety of gemstones that include emeralds, amethyst, aquamarine, tourmaline, garnets, and citrine.

It provides critically needed inputs for agriculture and agro-chemicals, industrial manufacturing of a wide variety of products e.g. ceramics, paint manufacture, the electricity industry, essential raw materials for the building industry, and for road and telecommunications infrastructure.

Available data from the 2001 Economic Report by the Zambian Government reveals that the sector rebounded in 2001 recording a growth of fourteen per cent (14%) in real value added compared to a growth of 0.1 per cent in 2000. The favorable performance of the sector was due to significant increases in copper and cobalt production in 2001. This marked performance of the sector was however achieved against a backdrop of low metal prices and disruptions of operations.

Increases in production were a result of privatization and expansion by international firms operating in the country. Privatization remained a key element of Zambia's structural reform programme. Among the privatized companies in 2000 were the remaining major assets of ZCCM, which was a major milestone in the privatization programme and private sector development. Prior to its privatization, the deterioration in the performance of ZCCM had adverse effects on the treasury (low tax revenue and rising government subversions), external sector (declining export earnings),

and in the real sector (declining employment and incomes). The main major assets of ZCCM were sold to two consortia.

The first consortium comprising Zambia Copper Investment (ZCI), Commonwealth Development Corporation (CDC) and International Finance Corporation (IFC), operating as Konkola Copper Mines (KCM), took over Konkola Division together with Konkola Deep Mining Project (KDMP), Nchanga Division and Nampundwe Mine.

The second consortium consisting of First Quantum Minerals and Glencore AG International, operating as Mopani Copper Mines (MCM), took over Mufulira Division, Nkana Mine, and the concentrator and cobalt treatment plant. Further, Nkana Smelter and its refinery were incorporated into a new subsidiary of Zambia Copper Investments (ZCI) plc called Smelter Company Limited (Smelterco). Anglo American Corporation is earmarked to manage this company, under contract, for five years. Privatization also saw the acquisition of Bwana Mkubwa Mine by First Quantum Minerals Limited who have transformed it into a modern mining set up.

In other words, levels of foreign penetration are extremely high; this is also revelaed by the table below.

| DIVISION / MINE | OWNERSHIP |
|---|---|
| Chambishi Copper Mine | China Non Ferrous Metal Industries Corporation |
| Konkola Division/KDMP, Nchanga Division, Nampundwe Mine | Commonwealth Dev. Corporation (UK)<br>International Finance Corporation (investment wing of the IMF) |
| Mufulira Division, Nkana Mine, the concentrator and cobalt treatment plant | First Quantum Minerals (Canada)<br>Glencore AG International |
| Nkana Smelter and Refinery (Smelter Company Ltd) | Anglo American Corporation (South Africa) |
| Bwana Mkubwa Mine | First Quantum Minerals Ltd (Canada) |
| Maamba Collieries Ltd | Kuyasa Mining (South Africa) |
| Ndola Lime Company Ltd | Socomer (Belgium) |
| Roan Antelope Mining Corp. | Binani Group of India (has since shut down) |
| Chambishi Cobalt Plant | Avmin Ltd of South Africa |
| Nampundwe Pyrite Mine | CDC of the UK |
| Kansanshi Copper Mine | Cyprus Amax Minerals of the USA |
| Chingola Refractory Ores Dumps | International Finance Corporation<br>CDC of the UK |
| Chibuluma Mine | Metorex (pty) Ltd & Miranda Mines of South Africa<br>Crew Dev. Corporation of Canada<br>Genbel Ltd of Australia |

Since 2001 though the government has been moving towards greater incentives for the sector. Some incentives and concessions granted to both local and foreign investors in some cases for a period of

up to 5 to 10 include reduction of royalty, corporate tax rate, greater deductions, lowering/elimination of other taxes and duties.

***Gains from privatization have also been documented in other countries. However, in the case of Zambia, another important factor needs to be understood. Though privatization occurred, care was taken not to allow a single owner to monopolize the industry. Though it is not clear why only two consortia were chosen and not three or even four, generally, the larger the number of players, the greater the competition, and the greater are the gains for the economy. It is also not clear why tax incentives need to be given. Competition between countries in giving greater concessions, especially in the minerals sector, is not likely to increase overall demand, but will only have a negative impact on revenue collections.***

**The Mining Sector – A summary**

The experience of both the countries reveals that there are ever-present pressures to provide fiscal incentives for greater FDI. However, there experience also reveals that these incentives need not be sustainable in the long run. In any event, in the case of derived demand commodities such as mining products, greater incentives are not going to have any impact significant impact on increasing overall demand for the products, but are only going to lead to lower overall benefits for the country.

Privatization can play an important beneficiary role in the sector and FDI entry has doubtlessly contributed to the high growth experienced in the sector. However FDI in long term return sectors is only sustainable if the correct investment environment is there. That environment requires two key components – a good economic-political climate for international business and a good regulatory structure.

## 3.5 The Processed Food Sector

**Food and Beverages Sector in South Africa**

SA is a global player in agriculture and agro-processing, particularly in food and beverages. Almost R4 billion (US$0.5 billion) in FDI since 1994 has led to a major restructuring of production techniques within the industry to ensure world standards. SA is one of only ten net food-exporting countries; agricultural sector exports in 2000 accounted for R14.6 billion or 7 per cent of export earnings.

A number of major SA companies have become significant players in the global food and beverages market, particularly those specializing in canned, frozen and dried fruit and vegetables; wines, beer and spirits; and other value-added products. They have an advantage over investors from abroad in that they have a better understanding of regional industrial trends and policy environments. SA retail chains in the region also import most of their stock from South African manufacturers and producers. Most SA investment in the region is of a resource and market-seeking kind, with

investors establishing a presence through management links via 'sister' companies or partnerships, and not in manufacturing industries.

The relatively highly developed nature of the sector in SA is due to many reasons. The first has to do with the traditional strengths in the agriculture sector. The second with the establishment of international firms many decades ago, this in turn has contributed to the competitiveness of the sector. The government's policy towards the sector has also been relatively more liberal than in other sectors.

The countries that currently have the strongest presence in the SA food and beverages industry are France, Switzerland, Italy, Canada, the UK and the US. These countries hold a dominant position in the local market through their TNCs, some of which are listed below.

| **Table 3.5: International firms with strong presence in South Africa** |
|---|
| Nestlé. |
| Unilever |
| Parmalat |
| Danone |
| Cadbury-Schweppes |
| Coca-Cola |
| Virgin Cola |
| Minute Maid |
| Pillsbury |
| HJ Heinz and |
| Kellogg's. |

The preferred form of entry for investment in SA is through merger and acquisitions, and JVs. This has been because there was a well entrenched domestic industry that had over a period of time acquired a set of skills in marketing and distribution not otherwise accessible to new entrants. There have also been several reinvestments in the industry. Some companies – including several of those listed above – have a long history of involvement in SA; newer investments by other multinationals were made following SA's post-sanctions democratization in 1994.

Mergers and JVs are the most common form of FDI in this sector and occur quite frequently. The concern has been that this is a simple exchange of ownership. In certain sub-sectors international domination is a threat to locals producers, and may effectively displace SA interests (especially if the economy is not growing). The dairy industry is a case in point; a strong European presence has led to the import of subsidized products from the EU rather than full local production.

***The food and beverages sector shows the important role the FDI can play. For one international marketing networks of established MNCs can play a strong positive role in accessing export markets. However, these networks also imply that if cheaper products are available elsewhere, those will be imported (even if unfairly subsidized). The key factor however should be seen to be related to employment generation. Agriculture is a sector that can provide high levels of employment and complementary sectors such as the food and beverage industry can provide significant avenues for its growth. Last, subsidization is an***

***important reality in many sectors, this should be dealt with in other international fora; foreign investment should not be made to suffer due to a problem in another area. South Africa has wisely followed this path.***

**The Agro-processing sector in Zambia**

The real growth rate in the agricultural and agri-business sub-sector has fluctuated significantly mainly due to the sector's high dependence on seasonal rainfall, reduced investments and the failure to strategically position the sector according to its comparative advantage. There were poor yields in the 1990's, due mainly to droughts experienced particularly in the southern parts of the country. Added to this, has been a decline in soil fertility (due to constant cultivation and over-application of fertilizers) in areas that have historically been the most productive.

During the pre 1991 period, the co-ordination of responsibilities relating to the small and micro enterprise sector (most enterprises in the agro-processing sector fall under this category) was generally chaotic with too many agencies sharing the tasks. The main ministry, the Ministry of Commerce, Trade and Industry (MCTI), was then charged with the responsibility for coordinating and developing policy for the sector.

Increasingly from 1983, the government decided to eliminate subsidies on maize and fertilizer, partly for the purpose of fiscal consolidation and partly to remove the distortions caused by the maize sub-sector. By 1994, all consumer subsidies on maize and maize products were completely eliminated and the prices were totally freed. Exports of all agricultural commodities, as long as they adhered to health regulations, became free and permissible and in order to expose Zambia to the competitive external market, imports of agricultural commodities and inputs (e.g. fertilizer and seed) were allowed and opened to the private sector as well. At the same time tariffs were cut. Additionally, all parastatals that were involved in marketing activities have been either abolished (e.g. the National Agricultural Marketing Board) or are earmarked for privatization.

The government has attempted to create a positive policy environment within which agricultural market liberalization could be consolidated. The policy and institutional improvements have focused in the last five years on outstanding reforms in the key areas of (a) consolidating the liberalization of agricultural marketing (primarily the elimination of subsidies to marketing parastatals and, subsequently, their privatization); (b) strengthening the liberalization of trade and pricing policy; and (c) streamlining the land tenure system to make it receptive to the policy of liberalization.

All the State Owned Enterprises (SOE's) in the sector have either been liquidated or privatized. Prominent among these were the the following;

- Zambia Cold Storage Corporation,
- Dairy Produce Board,
- Indeco Milling,
- Kawambwa Tea Company,
- Lint Company of Zambia
- Memaco farms
- Mpongwe Development Company

- Poultry Processing Company etc

Given such liberalization, it is not surprising that foreign penetration is important. However, there is a large concentration of firms from South Africa, though others such as UK also have some role.

| Establishment or Company | Foreign Ownership |
|---|---|
| Nakambala Sugar Company | Ilovo Sugar of South Africa<br>Commonwealth Dev. Corporation |
| Zambia Seed Company Ltd | Weibull AB (27.5% shareholding)<br>Swedfund International AB (25%) |
| Zambia Horticultural Products Ltd | Foodcorp of South Africa |
| Zambia Coffee Company Ltd | African Plantations Corp. |
| Zambia Cashew Company | CDC (12.5% shareholding) |
| Nchanga farms – Mukumpu Ipumbu farm | CDC |
| National Milling Co. | Erabus BV and Namib Mills |
| Nanga farms | CDC |
| Mpongwe Development Co. | CDC (70% shareholding) |
| Lint Co. of Zambia, Chipata Unit | Clark Cotton of South Africa |
| Kawambwa Tea Company | Metal Distributors of UK |

***Information on how foreign firms have been operating and how important a role they have played is not available yet. However, the policy directions that the Zambian government has taken are in the right direction. That is, privatization, lower government role in production and marketing, greater liberalization and openness. However, the agriculture sector is one where nature plays a very important role; and therefore year to year fluctuations are to be expected. This is especially true of areas that do not have adequate year-long irrigation potential.***

**The Processed Food Sector – A summary**

The food-processing sector tends to be one of the most important in developing countries from many perspectives. It has a high 'multiplier' effect in terms of generating employment across the economy, it tends to be a large sector in most countries whether open or 'closed', and it is the one manufacturing sector whose growth can come about from relatively low levels of investment in capital. Greater FDI in this sector leads to benefits that are somewhat different from those in other sector. Technology and quality improvements lead to better products for the consumers, marketing networks of MNCs can lead to greater exports (and greater imports as well), and it can also have a significant impact on improved farming practices through greater farmer-firm contact.

By creating the right environment that includes privatization, a competitive market structure, etc. governments can have a significant impact on the economy. This however works best when international firms with their know-how, technology, market-networks and expertise are also present in the market. Both South Africa and Zambia have gained from this 'tie-up' with international firms.

## 3.6 Other Sectors – A non-comparative discussion

### The Finance sector in Tanzania

The financial sector has been undergoing intense reforms since early 1990s. The objectives of these reforms included:

(i) Facilitating the attainment of macroeconomic stability;
(ii) Supporting structural adjustment in the real economy;
(iii) Providing effective support to the economy, especially by financial deepening and diversification in an environment of serious market competition.

Under its re-defined role, the Bank of Tanzania emphasis has been on the conduct of monetary policy especially adopting use of indirect policy instruments, open market operations and strengthening its role in banking supervision. This is important in ensuring resilient, well-regulated financial system, essential for macroeconomic and financial stability.

One important attribute of the financial sector reform was to allow operation of private commercial banks in the country. As a result of creation of new environment under which financial institutions could operate, a total of 19 banks and 10 non-bank financial institutions were established in Tanzania. Foreign banks by and large dominate the banking sector. Out of the 19 banks currently operating in Tanzania, 16 (accounting for more than 80%) have majority private foreign ownership while 2 banks are private local and 1 state-owned.

As mentioned, following liberalization of the financial sector, foreign private investors have dominated the private banking scene in Tanzania. Some of the benefits of influx of foreign investors in the banking sector have included transfer of technology and upgrading of skills.

As an example of three foreign banks that recently entered Tanzania shows, the improvements that have been so far recorded in the financial sector would not have been possible without a massive transfer of technology through bringing in skilled expatriate banking personnel, on the job training and sending local staff abroad in specialized training institutions. Many of the new foreign investors have also introduced programmes where locally recruited staff is sponsored by the firms to obtain further training in formal learning institutions within Tanzania or abroad.

***These contributions do not necessarily come up automatically but are determined by government policy, including the establishment of the competitive environment on the one hand and strengthening existing institutions, reinforcing the regulatory system and putting in place an effective supervisory mechanism on the other. Only time will tell how efficient the new regulatory system is, but available evidence suggests that right path is being followed.***

### RMG and Textile Industry in Bangladesh

The textile sector traditionally has been the largest manufacturing sector in Bangladesh. Currently, Bangladesh's textile sector contributes more than 5 percent of the country's GDP, it earns more

than 70 percent of country's export earnings and employs some1.6 million people. The overall liberalized environment towards FDI along with cheap labor cost has been important for attracting FDI in this sector. However, other government policies also played important role. The Government of Bangladesh provides many incentives and support.

The textile industry of Bangladesh is now comprised of more than thirty sub-sectors. The major sub-sectors are: spinning, weaving, dying-printing-finishing, knitting-knit dying & finishing, and readymade garments (RMG). Starting with 9 factories in late 1970s, the RMG sector now has some 3000 factories that employ about 1.5 million workers. Real growth rate of exports of RMG was 12%, (about two and half times of GDP growth over the matched period), The RMG activities not only propelled the growth of accessories and spare parts, but also rendered tremendous externalities by increasing other economic activities in such areas as banking, insurance, real estate, packaging, hotels and tourism, linkage and recycling, consumer goods utility services and transportation.

Aggregate figures on actual investment data are virtually non-existent. However, data shows that bank advance (excluding working capital) experienced significant growth in this sector. The index of RMG production also rose eight-fold within 12 years between 1989 and 2001.

In the mid nineties, the government identified the textile sector as the thrust sector. The Ministry of textile came up with a new textile policy in 1995. The main objective of this latest policy is to attain self-sufficiency in textiles for meeting the local as well as the export oriented RMG demand for fabrics. Accordingly, government has designed an incentive package that is conducive to encourage investment in the textile sector directly, as well as indirectly by stimulating profitability at least in the short and medium run. The package includes different fiscal, financial, and institutional instruments.

RMG sector of Bangladesh grew without a matching growth in its backward linkage activities until recent years. Such lopsided growth of RMG sector has been possible because of the protective environment due to the preferential market access under the MFA and GSP regimes, and various supportive policies of the national government. However, existence and sustained growth of RMG would be contingent upon improved quality, diversification of products, increased efficiency, and of course, the dynamics of global trade in textiles and clothing. One of most important factor associated with its competitive advantage is the development of domestic efficient and dynamic backward linkage capacity.

It is difficult to quantify the exact magnitude of FDI in textile and RMG. Total investment in this sector is more than 250 million US dollar within the EPZ; most of this investment is in firms either wholly or partly owned by foreign entities (joint ventures).

***The case of the RMG sector reveals that countries can benefit in the short run from advantages offered by changing international trade regimes. However, in the long term, sustained growth would require a strong base of domestic productive capabilities. FDI will occur only when these conditions appear. Bangladesh has exploited its advantages of cheap labor and combined that well with the opportunities offered by regimes such as MFA. The base now exists for Bangladesh to build upon. In all likelihood even when the temporary advantages disappear Bangladesh's outward oriented and open policies will ensure storng growth in the sector.***

**Cement Industry in Bangladesh**

Cement is one the most important construction material. Nature of growth in the construction sector requires a faster growth of the demand for cement. The experiences of the last few years suggest that demand for cement grow at a 10% rate per year indicating good conditions for profitable investment.

The construction sector is considered to be one of the highest growing sectors in Bangladesh. Average growth rate in construction sector is around 8% while the average growth rate of the economy is 5%. Data indicates that investments were quite low on cement and asbestos industries until 1995. However both production and investment in the sector has been increasing rapidly since. However, value addition in the cement sector is quite low as all these new industries are grinding mills that transform clinkers to cement. While Bangladesh imported cement from Thailand, Indonesia and Malaysia until the recent years, presently it imports clinkers from these countries to grind into cement.

At present there are some 52 cement factories in this country. Most of them are relatively small units. Many units have been constructed as joint ventures and on foreign investment. Total investment in the largest forthcoming capacity plant is US $ 242 The total of all other foreign investment in the cement sector is much lower than the investment of Lafarge. The basic driving force for FDI towards the grinding mills was large and growing demand for cement, tariff differential between import of clinkers and cement, fall in clinker price from East Asian countries after the East Asian crises etc. Foreign firms are observed to perform marginally better than local firms. Average size of the business and employment per firm are higher for the foreign firms.

Perceptions of local cement manufacturers indicate that FDI in this sector has resulted in a decline in their sales, but it has increased product quality. Cost of skilled labor has also increased. According to the civil society perception, however, foreign investment in this sector had positive impact on quality of product, prices of product, and choice of consumers.

***Bangladesh's experience with the cement sector has important ramifications for FDI in small markets. One large investment has the capability to overpower all competition from the domestic industry. Competitive markets can rarely survive in such a situation. It would be natural for domestic industry to suffer with greater FDI. An economic policy that is oriented towards low costs and consumer welfare will tend to support opening up of imports (such as from India, Nepal and MyanMar) along with greater FDI. The regional markets could also provide larger markets for Bangladesh's own low cost (based on low wage) domestic production. Good economic policy requires both FDI and trade to be opened.***

**Pharmaceutical Sector in Brazil**

In 2001, the Brazilian pharmaceutical market represented about US$5.3 billion (drugstore sales), including the hospital market; this value would be US$6.7 billion. Of this, domestic companies

(which are among the largest 50 in the sector) have between 16 and 20 percent of the market. The rest being dominated by MNCs.

The pharmaceutical industry can be analysed, based on the four stages that compose the productive process

a) research and development (stage 1);
b) production of pharmaceuticals (stage 2);
c) Production of drugs (stage 3); and
d) marketing and trading of specialties (stage 4).

In general, large multinational companies tend to operate in all these four stages internationally. However in Brazil, the majority of multinational subsidiaries operate in stages 3 and 4. Domestic capital companies also operate, for the most part, in stages 3 and 4. Though the MNCs have all the elements to operate in the four stages and, for strategic reasons and local feasibility, they, in general, operate in stages 3 and 4, buying pharmaceuticals from third parties, in the domestic market or abroad.

In 1996, the Brazilian Government approved a new Intellectual Property Law (that has been in operation since 1997), which recognised patents on pharmaceutical industry and prohibited copying of patented drugs marketed under different brand names (the so-called "similar"), an usual practice in Brazil, mainly for local companies. This Act, besides the Real Plan, was an important factor behind the attractiveness of Brazilian market for FDI during the nineties.

Moreover, it altered the strategy of many companies in this sector, local and transnational, since it allowed the production and marketing (especially the last one, for reasons explained above) of new branded drugs. Finally, it provided the legal base for the Brazilian Government to implement a generic drug policy.

The Act of Generic Drugs was another important policy development. The act allows the production of drugs with no brand name by local laboratories. It has had different impacts on domestic and foreign companies. In the case of domestic companies, it has reduced the problem of low scale production, and consequently made stage 2 within reach for domestic firms. Hence, domestic laboratories are expanding rapidly and, consequently, increasing the potential for having a more significant local industry in the second stage. In the case of foreign laboratories however, it has increased the possibility of patent-breaking to register medicines as generic. This represents a threat commonly used by the Brazilian Ministry of Health to negotiate price reductions for products of continual use in medicines that are part of the Brazilian programme to battle AIDS.

Recently, the infrastructure of universities has been used for tests required for the approval of generic drug production procedure. Hence, these institutions have accumulated technical knowledge needed for the expansion of stage 1 in the country. The Industrial and Technological Development Programme (PDTI) from Ministry of Science and Technology is important as an incentive policy for stage 1 development.

***The Brazilian pharmaceutical industry shows the strong interplay between regulatory and legal issues and that of FDI. An industry that has been largely controlled by the MNCs has recently shown high levels of activity due to some policy changes that loosen the IPR to***

***some extent. Though this may have a positive impact on domestic production, (and as a result perhaps prices) it is not clear whether the country will gain in the long run as it may slow down entry of new substances owned by large international pharma firms. Policy however is dependent upon many factors of short term and long term interest, in Brazils case clearly, recent decisions are aimed more at increasing competition, and MNCs that depend upon IPRs will be harmed somewhat. How these pressures play out and what will be the overall impact on Brazil only time will reveal.***

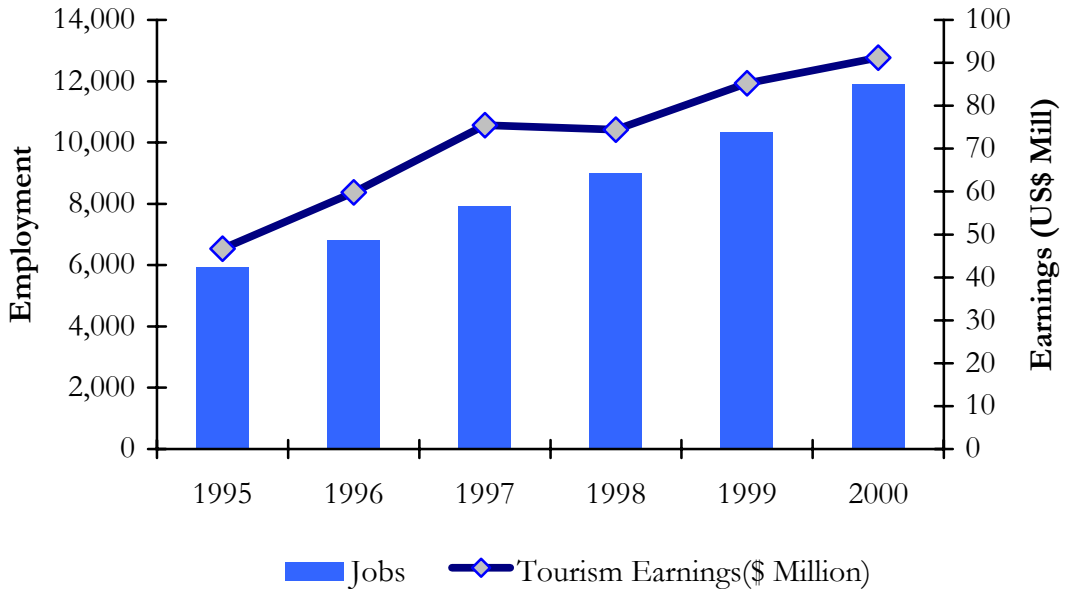
**Tourism Sector in Zambia**

The tourism sector a conducive environment for private sector participation, environmentally sustainable growth, and good governance. This requires policy improvements, institutional and legal framework adjustments, etc.

The sector is a labour intensive industry and provides jobs for local people in urban and rural areas where most of the poor people live. In addition, it stimulates entrepreneurship and creates opportunities. The benefits of these additional resources can be channeled towards improved nutrition and food security, housing, health and education and, consequently, improve the communities' living standard.

Tourism has experienced some positive growth with foreign exchange receipts increasing by an annual average of 13 per cent between 1995 and 2000 or an absolute increase from $47 million in 1995 to $91 million in 2000. The number of tourist arrivals increased from 163,000 in 1995 to 457,419 in 2000. In terms of employment creation, the sector has contributed about 12,000 jobs to formal sector employment of about 475,000 up from about 6,000 in 1995.

**Figure: Growth of Tourism: Impact on Zambian Economy**




Zambia has considerable untapped natural resources for tourism development. They include abundant wildlife, rich cultural and natural heritage sites, abundant water resources, peace, and tranquility. The country has 19 National Parks and 34 Game Management Areas (GMAs) covering 33 per cent of the country, but only 5 per cent of this has been developed for tourism.

Table: Foreign Ownership of Hotels

| Hotel | Foreign Ownership |
|---|---|
| Zambezi Sun | South Africa |
| Royal Sun | South Africa |
| Taj Pamodzi | India |
| Intercontinental | |
| Holiday Inn | South Africa |
| Protea | South Africa |

The government's role in the growth of the tourism sector is to facilitate private sector involvement through investment promotion, marketing, and provision of infrastructure and supportive legislation. In facilitating the growth of the tourism sector, resources will be directed towards high growth areas. These areas have been prioritised into development zones and national programmes in the Tourism Development Master Plan.

In an effort to stimulate investment in the tourism sector, the Government offered several incentives to the sector. These included the reduction in corporate tax for tourist operators and recognising them as exporters of non-traditional exports, allowing a re-claim of VAT on costs incurred in establishing tourism enterprises, and zero-rating for accommodation offered by hotels, lodges and guest houses in Livingstone District for two years. The list of tourism activities that are

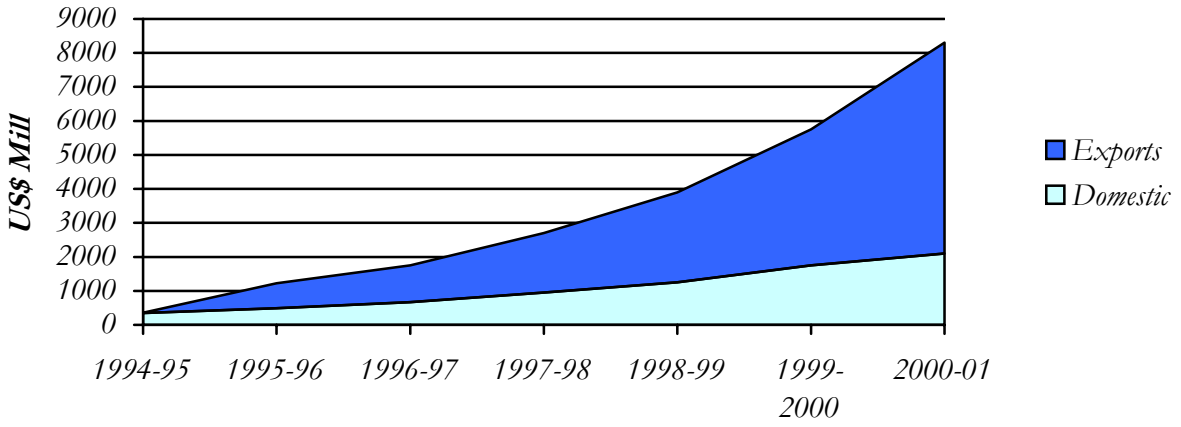
VAT zero-rated was extended to include boat cruising, micro-lighting, helicopter tours and walking safaris making the product competitive regionally. Duty on the importation of aeroplanes of any weight has been removed and the waiver on tourist visas has been re-instated.

***The government in Zambia has largely been trying to provide a good environment for the tourism sector. In doing so it has managed to ensure high growth in tourism sector and as a result on employment. More significantly, this policy has involved low government intervention in the tourism sector. Policies such as those on elimination of tourism Visa, tend to have a strong positive impact and are economically costless to the government. The Zambian tourism sector case strongly suggests directions for good policy – low government intervention and an enabling environment.***

**The IT Sector in India**

One of the most remarkable developments of the 1990s in India has been the growing emergence of the `new economy' or the *IT* economy. To be specific, the IT economy comprises all the activities involved in value addition (i.e. GDP), adjusted for exports and imports, by way of IT services, software systems and communication equipment, such as computer companies, telecommunication utilities and related enterprises. The major segments of IT -enabled services are content development, medical transcription, call centers, database services, support and maintenance, training/retraining products and packages, projects and professional services.

**Figure: Revenue Growth in Software Sector**




The base for the industry was formed in the seventies when graduates from the engineering colleges and other institutions of higher scientific learning started to venture out in the software development field independently. Larger Indian companies were marked by their absence (except two – DCM which stagnated sometime in the eighties, and TCS – which continues to be the largest IT firm) in the initial stages. And so were MNCs – IBM had been asked to stop operations in the country in 1977-78.

The evolution of the Indian software industry has only in recent years been intimately linked to the trend of globalization of the value adding activities in large MNEs. Though the first instances of MNC participation date to the middle eighties. It was Texas Instruments (TI), a US based MNE, which had set up a software development center in Bangalore as far back as 1986, to tap the highly qualified workforce available in the vicinity. Subsequently, a host of others MNEs began to follow the footsteps of TI. Seeing the potential, a number of Indian companies engaged in computer hardware started to spin-off their software divisions. Despite the entry of most leading MNEs in India for software development, the industry is still dominated by domestic companies.

The Indian software exporting companies themselves are sufficiently global in their outlook. As many as 212 Indian software companies have either subsidiaries or branch offices overseas. Many arenow listed international stock exchanges such as Nasdaq in the USA. Hence, Indian software industry is very intimately linked to the emerging trend of globalization and outsourcing that is taking place worldwide. Moreover, almost all major international software related firms now have substantial presence in India. Microsoft, Oracle, and Adobe are some that are better known, that have consistently been expanding their presence.

The success of the Indian IT sector has generally been attributed to the role played by the government in providing an enabling environment, but not strong policy intervention. This was predominantly related to the setting up of institutions of higher learning and maintaining high standards in their functioning. Moreover, many constraints that normally beset manufacturing facilities are not present in software services.

However, the government did periodically come up with some policy measures. It is not clear what there impact was. In all likelihood, it was marginal. In 1986, a computer software policy was formulated, a Software Development Agency was set up and entry into the software industry was de-licensed. In 1988, the Electronics and Computer Software Export Promotion Council was set up to provide marketing help to software companies. Other government efforts such as the setting up of Software Technology Parks (STP), improving telecom infrastructure etc also occurred.

Most importantly, the industry also re-organized itself and set up the NASSCOM as their apex body to lobby for their common cause with the government. NASSCOM has been one of the most successful lobby groups in the country, and many micro and fiscal policies were put up because of its efforts. Since then the government has come up with an 'Action plan' which includes opening of Internet gateway access, encourage private STPs, zero duty on IT software, income tax exemptions to software and services exports, etc. As a follow-up of the Action Plan, a new Internet policy has come into being and a large number of internet service providers have been licensed. Now, a separate Ministry of Information Technology has been set up to co-ordinate the promotional role of the government and the industry.

***India's IT story is important for many reasons. However, the key aspect is related to the (non) role of the government. It can simply be summarized as a case where the government provided an enabling environment by creating and aiding well run institutions of higher learning, and improving telecommunications infrastructure. Credit was rarely given to firms, or given with great difficulty. Hardware imports were taxed at high rates. It also did***

***not provide many incentives in the initial phases. Most incentives came later. Large business – both domestic and international – also did not initially see the potential of this sector. Individual efforts in a friendly environment were the basis for the strong roots that this sector has taken.***

***Similar lessons apply to FDI as well; governments need not specifically attract FDI, they also need not provide great incentives for the same. All that they require to do is to provide an environment that is enabling, not inimical.***

# V. Potential and Actual Flows of FDI in Project countries: An Assessment

Earlier sections have shown that a large part of the variation in FDI is explained by the structural factors. Given this evidence **one should not proceed with a premise that "there are no limits to FDI"**. Instead, it is important to understand that given the characteristics of each specific country; there would be some 'limits' to the FDI that can be expected. Unlike others, this study *identifies* broadly the level of FDI that can be expected. Moreover, it then compares the expected with the actual. This *comparison* allows us to identify for each country the specific positives and negatives that affect FDI.

However, the bulk of the methodology is not reported here, the reader can refer to the appendix for details. What is of more interest are the *specific* insights that we are able to derive. These form the bulk of this section. This by itself would be a complex exercise given the range of factors that have been studied. Consequently we have **chosen a central theme for each country** around which the discussion occurs. This discussion format is not merely for presentation purposes. There are many factors that need to be changed or strengthened; rather than going about that in ad-hoc fashion, countries would achieve more success if they were able to (i) prioritise and (ii) provide a structure to policy reform. The idea therefore is to put forth one or true central themes around which changes could occur in the project countries.

## V.1 Bangladesh Could Attract More FDI

The potential for FDI with steady growth and improvement in the size of the market emerged only in the mid-nineties. As such today there is potential for substantially more FDI than the current level of about US$ 170 million. Thus, Bangladesh can do with a lot more improvements in FDI related policies, including **promotion**. It needs to **draw attention to its strong economic performance** to attract FDI. This is especially so since FDI tends to show bandwagon effects. The relatively high and sustainable economic growth of Bangladesh, based *inter alia* on exports has not yet drawn the attention of source countries and firms.

Given the fact that MNCs **can make efficiency gains** through investments in garments where labour cost are very low, restrictions on FDI to enter this sector needs to be re-evaluated. It may be recalled that exports from Bangladesh have grown rapidly in recent years providing indirect evidence for potential of efficiency seeking FDI in those sectors where **exports are high**. **Garments** happen to be one of the most important sectors in that category. Besides, opening up of banking, insurance

and financial sectors may attract more FDI into this emerging market. While infrastructure was seen as a factor resulting in non-implementation of approved FDI proposals, **it is not clear if infrastructure is the key reason** for Bangladesh not attracting FDI according to its potential. Political risks are seen to be still high but good growth for some more time should make the economy more creditworthy in the eyes of international agencies.

Overall, Bangladesh can attract a lot more FDI, and need to worry about bringing regulatory and policy clarity, and in the business environment, to able to attract more FDI, given the already open policies that welcome FDI into infrastructure and participation in privatisation. In Bangladesh, with weak entrepreneurship, but with strong growth factors given the commitment to not allow the Taka to be overvalued, FDI in export industries can further the growth effort. Higher growth will in turn enhance the structural potential of FDI.

### V.2 History, Macroeconomic Policies, Regional Markets & Privatisation Drive FDI in Brazil

In the case of Brazil, except for a brief period in late 1980s and early 1990s, the actual FDI inflows have always been larger than the 'potential' as indicated by the structural determinants (Figure 2). Several factors are responsible for the high propensity of FDI flows into the Brazilian economy. The historical development of a **strong manufacturing base** is an important factor. Brazil like much of Latin America, has been open to both capital movements, and has had liberal FDI policies for a long time. Indeed, except for short periods Brazil has been open on the capital account. Brazil's **economy diversified** a great deal during the two world wars because the spurt in demand brought by the wars. The immediate post war import substitution also contributed to its industrial diversification. In the sixties and the seventies as Brazil opened itself to multinationals, a process of dependent development of Brazilian industry (but with high growth rates) took place (Evans, 1983). This rapid growth and diversification in a period **when MNCs were allowed in liberally**, was the key reason for the high FDI stock in Brazil.

Much of the highly profitable and strategic segments of the industry were occupied by multinationals -drugs and pharmaceuticals, automobiles, electrical and electronic goods, life style associated products like cigarettes. The public sector dominated oil distribution and refining, many other utilities, and local capital with links to MNCs in supplier and older industries like textiles, cement, and in retail trade and distribution. A factor that allowed such deep penetration by MNCs was, besides the technological and organisational superiority, their financial advantages at a time when domestic abilities were not as advanced.

The liberalisation of the nineties followed the fiscal and macroeconomic un-sustainability of the late eighties. Today, an **economy that is deeply penetrated by MNCs** in manufacturing, is being penetrated in the services sector especially utilities, as privatisation proceeds. Such large volumes of FDI lead to income payments abroad, but not generate export revenues.. Until a well functioning all-American preferential trading arrangement emerges, **MNCs and their international marketing networks** are an important option for realizing greater exports. In other words Brazilian owned enterprise has been somewhat weak in generating international revenues, and international FDI is now moving towards areas that are not likely to

Earlier FDI inflows into Brazil were designed to serve the entire Latin American markets, as labour costs were low. The 'maquiladora' industries of Mexico, which took off after the emergence of NAFTA has led to rather large decline in the labour intensive, export enclaves of Brazil. Thus, the

regional market advantage not captured by our model but which could have contributed to larger than projected FDI flows may be on the decline. Despite this, since the mid-nineties, FDI into Brazil has been far higher than its 'potential'. The **active privatisation of both regulated and other industries**, and the withdrawal of the state in the face of a handicapped and much weakened domestic private sector, has been a large contribution to this FDI. That much of the flows have taken the form of mergers and acquisitions results from the fact that FDI has been pulled in to a large extent by major policy (not limited to foreign investment) and regime change rather than by growth in the market as such.

Broadly then, in Brazil large investments came along with vast income outflows. Continuing FDI is in areas that are not likely to improve the long-term balance of payment conditions. **The leverage point does not lie in FDI related policies per se, but primarily in broader processes.** These have to do with two areas: One, **a strengthening of domestic economic base**, of international agreements, and labour market issues, that will make Brazilian output (manufacturing, agriculture, and services) more competitive internationally. And two, macroeconomic and other measures that can **reduce capital flight and raise domestic investment rates**.

### V.3 Hungary is Using FDI to Re-integrate, Privatise & Cater to Regional Markets

In the 1990s, Hungary has been receiving more FDI than its structural potential (Figure 3), probably reflecting bandwagon effects and its status as a secondary metropolis in Eastern Europe, and the special significance of Germany, France and Austria re-establishing their hierarchical relationship with Hungary.[7] Besides its own markets, Hungary as **a source of cheap labour for manufacturing product exports** to the richer European countries including the EU, is an important factor. Hungary based MNCs thus cater to the larger regional market. Additionally, the **vigorous privatisation activity**, which has put on the block its vast earlier state run enterprises, has also significantly contributed to the FDI inflows. In the near absence of a local capitalist class of substance and strength, much of the privatisation of SOEs would have to take the form of FDI. Lower corporate taxes, state subsidies for large-scale investments in high-tech sectors and ability to keep books of account in foreign currencies in EPZs to overcome foreign exchange risks seem to add to Hungary's advantages listed above. However, it is not clear whether all of these measures are sustainable.

Overall, in Hungary, the story is of **re-integration** with the centre of Europe in France and Germany, market access to the EEC, with vast factor (labour) cost advantages. The **endowment of scientific abundant and technical skills**, due to the earlier Soviet System is now an advantage. FDI is the indispensable vehicle in that process. However, due to liberal capital account policies, the potential for capital movements (short-term capital flight) to disturb the process is large.

### V.4 Growth Oriented Policies and Regulatory Clarity are Critical for India

India is another country, which relative to its predicted FDI could have attracted a lot more during the 1980s and early 1990s. The gap between its potential and actual flows which had been very large in the eighties, due to **severe restrictions, have now narrowed down**, as these restrictions gave way in the early nineties. But since stabilisation reduced growth, the FDI potential collapsed in the early reform period, only to rise sharply, as India made a smart recovery and the FDI factors became favourable. Post 1995, for a short period FDI inflows outstripped the country's structural potential.

[7] The figures according to the UNCTC /UNCTAD based on OECD and other survey data that go beyond the balance of payments flow data used in this analyses show much higher inflows (See Table 13).

After the late 1990s, however, **potential remains higher than the actual flows**, although the divergence is not as high as it were in the 1980s. Indeed, if the current **lack of regulatory and policy clarity** in areas like power, water, sanitation, roads and airports can be overcome, increases in FDI are possible. It may be recalled that **privatisation related FDI inflows have not been as high** in India as in many other project countries. Similarly, there are many sectors, **especially services** - banking, insurance, and real estate -where with liberalisation more FDI can possibly flow in. With the industrial growth downturn since 1998, **FDI potential may well have fallen**. But a significant increase may even now be possible if the policy and regulatory clarity that restricts private investments in general are overcome.

While policy changes and regulatory clarity can lead to higher FDI inflows into India, (especially through the privatisation route), **policies to enhance growth** are also critical. These will enhance the potential of the country to attract FDI. Many believe that the rate of growth of the economy can be enhanced significantly through a better policy mix. Enlarging the market size is critical for India to be in the same league as China.

### V.5 Growth Oriented Macro Policies are needed in South Africa

In the case of South Africa, the realised **FDI has been much below the "potential**". As mentioned, our FDI figures are net rather than gross and there was substantial retirement of FDI as many companies changed their headquarters to UK and Netherlands as the apartheid regime gave way, resulting in negative inward FDI flows. Since then other factors like increasing crime and **law and order problems**, would have restricted FDI too much below its potential. In South Africa the **focus ought to be not so much FDI related policies** as much as more general policies that **enhance growth, investments, and especially exports**.

Apart from these a few other issues may need to be sorted out. South Africa is the only country among the project countries that has **restrictions on MNCs** in some sectors regarding local borrowing, hiring of minimum number of local employees, ownership of immovable property and maintaining a capital base (see earlier discussion). Besides, there is **evidence of significant regulatory uncertainty in the services sector**. It is important for the policy makers to ascertain the extent to which such restrictions and uncertainties have impeded FDI inflows and take corrective action.

South Africa has **a dominant and focal status within the region** and has great potential for economic development given its size, resources and location and skills (which of course need to be improved). But **premature liberal capital account policies** have contributed to capital flight and reduction in the growth potential.[8] Besides, the social unrest too has had its toll. Thus, apart from a few FDI policies referred to above, overall growth and development policies are important.

### V.6 The Tanzania Case Requires Further Exploration

The comparison of potential and actual flows of FDI into Tanzania is very difficult, as data required for estimating the potential is not available for most of the period under study (Figure 6). However, with what is available one can ascertain wide fluctuations in FDI. Broadly it seems that the **realised FDI is lower than what could be achieved**. Higher growth rates have enlarged the market in

[8] In 2000, the foreign investment allowance for private residents in South Africa was raised to Rand 750,000. According to some this has amounted to state sanctioned capital flight. Some estimates reported in the country paper suggest that since 1997 about R 17.4 billion have left the country.

recent years but have not led to a significant increase in FDI inflows. It is possible that the 'tax-break' tournaments in the region to attract FDI puts countries with **infrastructure and skill linked contraints** such as Tanzania at a disadvantage. This may be particularly relevant now as **trade barriers within the region are breaking down**. For tradables, FDI can flow to most attractive locations and cater to the region. **Perceptions of high political risks** add to this disadvantage of the nation.

### V.7 Zambia Exemplifies a Case of Governance Failure

Zambia went through major stress during the nineties with **economic growth having fallen** dramatically before it recovered somewhat from the major contraction-ary structural adjustment and 'stabilisation' that the economy went through. The **large capital flight from Zambia** was also a result of this macro-economic instability. High inflation till the contractionary policies brought about severe deflation underlie these large variations (Table 23). **Zambia therefore is different** from the countries studied in major ways – small, but having a rich resources base, significant governance failures, and capital flight. **Perhaps for countries such as Zambia an altogether different economic and development model is required**, which has to be part of a more general one that characterises its economy. Not much more can be concluded without data that is more detailed.

Nonetheless, if we focus on the 1990s alone and disregard the large fluctuations in the earlier period, **potential FDI seems to be higher than what has been achieved**. Since **resource seeking is the key driver of FDI** here, fall in international prices of copper would also have led to limited FDI inflows in the country. It is **unlikely that tinkering with FDI policies would make any difference to FDI inflows** unless **larger issues of governance failure** are dealt with.

In many African countries, and more so in Zambia than Tanzania, the problem is a more basic one of the country lacking the structure to retain economic surpluses within the economy. Table 23 provides estimates of capital flight from African countries and Zambia is among the top. Inappropriate stabilisation programmes, and especially structural adjustments, that assumes the existence of an ever ready private sector, have further contributed. They compounded the problem of growth and transformation.

### V.8 FDI Inflows into Project countries: A Comparison with East Asia

As mentioned, recent years have seen significant FDI inflows into many East Asian economies. It may be is interesting to compare the FDI flows in the project countries with FDI flows in the East Asian Tigers. This section attempts this comparison with China, South Korea, Thailand and Japan. These countries have indeed received much more than FDI than most of the project countries. Have the FDI flows into these economies more than their structural potential?

*China: Flows Driven by Growth and Round Tripping*

In China quite like in India the actual inflows in the eighties were below the potential (Figure 8), both because of restrictions that allowed Chinese enterprise to mature during the eighties and early nineties, taking advantage of the stupendous growth of the Chinese market. Later in the nineties the observed flows became much higher than what is projected by structural features. This was partly because of greater liberalism in FDI policies especially in the areas where Chinese enterprise was weak -life style associated products, automobiles etc. The apparently larger than predicted FDI since 1993 is when the round tripping mentioned earlier became an important phenomenon, as corruption in China reached epic proportions. The Chinese exports slowed down in the second half of the

1990s, due to the slowing down of the world economy, and moderate appreciation of the real effective exchange rates from extremely low values before. This resulted in slower (approximately 8% instead of the 10-11 % earlier) GDP growth rates, which brought down the potential of FDI into China. If we recognise round tripping, even today, actual FDI flows is much below its potential!

*Thailand & South Korea: Crisis Brings in More FDI in the 1990s*
In both Thailand and South Korea, the actual FDI inflows after the mid-1980s have been below the structural potential of these countries (Figures 9 & 10). This changed after the 1990s East Asian Currency Crisis after which FDI inflows have zoomed in the wake of asset deflation which made available to MNCs largely of Western origin, worthy enterprises at low values.

*Japan: FDI Inflows have always been Below the Potential*
Interestingly, in Japan too the actual inward investments have been far below its potential (Figure 11). This was essentially due to the restrictive and nationalistic policies that Japan had followed during its entire industrialisation starting right from the Meji Restoration in 1869 to the late eighties. Its enterprises in manufacturing have great ownership advantages that are amplified by the idiosyncratic location advantages that are uniquely exploitable by the Japanese firms, and not typically by Western firms. The industrial structure of the Kieretsus that result in great efficiency remains a barrier to entry.

Julie et al (1998) show that the intra regional FDI in East Asia and South East Asia are far too large to be explained by close geographical distance or by any other conventional economic factors. They have had their origin, in the initial stages to Japan's export led growth and its need to retain competitiveness via FDI in low cost economies and later to the cross-national links of the Chinese bourgeoisie in the region.

In conclusion, it needs to be emphasised that when properly considered many of the East Asian economies, despite seemingly more inward FDI, have in reality attracted less relative to their structural potential. And this was essentially due to the less liberal policies adopted by these economies during their transformation period. Higher foreign inflows in the late 1980s and 1990s were due to liberalisation of capital and other controls. As discussed above, the larger flows have also brought in uncertainties of different kinds. In Latin America and Africa, where FDI inflows have been large, these have sometimes led to dysfunctionalities. Indeed, many of these economies are largely dominated by MNCs, which continue to consolidate their position via increasing FDI. In the 1990s generally FDI has happened despite rather poor growth perhaps leading to displacement of domestic investments.

## V. Some Concluding Observations

The last section analysed the FDI inflows into the project countries vis-à-vis their potential and identified a few elements that could have led to these gaps. This concluding section views the key insights from the synthesis of the seven project countries in the context of the nineties when worldwide a liberal policy agenda has become acceptable. The insights are however also drawn from the experiences of other countries.

The decade of the nineties, which is also the period of this study, is remarkable in many ways. The period from about the late eighties to the mid-nineties saw many LDCs substantially liberalising their economies, and attempting to 'globalise'. In many countries these changes were linked to the 'stabilisation' programmes of the IMF and the World Bank. In the East Asian economies, they were attempts to globalise after a very successful period of exports led growth from the sixties and the seventies, that had come from within these economies.

*The International Growth Experience*

As discussed, FDI flows are intricately linked to the growth processes underway in the international economy. The advanced capitalist countries as a group showed very rapid growth rates after the Korean War till the mid-seventies. A period of recession followed. The recovery from the recession, which was sporadic, picked up in mid 1980s. The US recovered first and had a boom on the back of the information technology revolution from 1988 or so. And interest rate targeting under President Clinton extended the boom period right until the IT collapse. This was followed by a fall in consumer spending fall and the September 11 bombings, which had a depressionary effect in 2001.

A fairly common pattern for much of Latin America (e.g. Brazil) and Africa was the high growth during the period up to 1973 or so. With the collapse of the Gold Exchange Standard, and the recessionary trends that had set in, in the advanced capitalist countries, falling raw material prices and demands, many such countries went into the Debt Crisis (e.g., Zambia) from which recovery was often slow and painful. In some nations, this relative decline in the growth and trade prospects led to more open policies as in South East Asia, in others it may have led to a greater role for the state, often a dysfunctional one. This contributed to to fiscal and macroeconomic un-sustainability. Countries such as India, China and Bangladesh where the domestic drivers of change were far more significant showed other patterns not necessarily related to the general pattern of increased openness till 1979 or so.

Thus, today in the depressionary situation globalisation is facing significant difficulties. But the liberal agenda of the privatisation, increased foreign investment both direct and portfolio and increased openness on both trade and capital flows continues to be actively sought and pushed, with some significant reversals such as the re-imposition of capital controls in Malaysia. **High expectation of large FDI inflows in such a scenario may be misplaced.**

*Liberalisation and Possibilities of Capital Market Failure*

**With practically no exception, nearly all countries turned towards the liberal agenda**. In most, prior state failure (of varying degrees) had been significant, and was an important contributory factor. Consider the East Asian NICs that had successfully used state intervention (in varying degrees) and co-ordination within large private entities such as the *Chaebol*, to overcome market failure. The motivation in going liberal arose out of the strong voice with which the ideology of globalisation was being put forward. The benefits were then perceived as being automatic - increased access to foreign savings to raise the already high investment rates even further, and hence of the prospects for higher growth and greater share of the world market. The ease of repatriating funds, and low tariffs, have been identified as some of the key enabling factors.

Since then however Malaysia has become stricter on capital controls, and South Korea and Taiwan have 'accepted' far lower rates of growth. With asset deflation, that reduced values of factories, plants and companies to far below what was reasonable from their long-term productivity, acquisitions by MNCs were immensely profitable. **In other words, the currency crisis forced**

**upon these economies a great shortage of foreign currency assets, a shortage that resulted in distress sales.**

With the East Asian crisis and now the recession, the growth rates have fallen in most parts of the globe. The experience has also highlighted the problems that may emerge with liberal policies combined with limited controls on the capital account. Despite this, the liberal agenda continues. **A reversion to a greater role for the state is far less credible, given widespread instance of state failure**.

*Role of Policy Liberalisation in Attracting FDI may have been over-emphasised*

The debt crisis of the early eighties, which had severely affected the Latin American countries, reduced the share of LDCs for almost a decade that followed. Virtually all countries with the notable exception of China and possibly Korea have become distinctly open to FDI in the nineties. In some countries such as India the change from highly restrictive policies to very open regimes have been dramatic. Indeed, **today among LDCs there is a veritable 'locational tournament' that has come about as LDCs vie with one another through tax and fiscal concessions and other incentives to attract FDI and multinationals**.

However, we have seen that net flows of private capital in the developing countries have been rather small. FDI has had a share of around 20 to 25 per cent for the LDCs as a whole if the special case of East Asia is kept aside. **As such, there is really no case of FDI flow shares of the LDCs as a whole having gone up in the nineties, and therefore, of the optimism that FDI per se can solve the problem of investment**.

*State Failure, Privatisation, and Liberal Policy Regimes*

The collapse of the Soviet Union into anarchy and its slow and painful evolution to capitalism has had far reaching effects upon the world including the LDCs. The liberal agenda, which had been posited against the state as a polar opposite, has become virtually unchallenged with no apparent alternative.

The success of Britain in the 1980s and the US since the deregulation movement began, saw many public services being affected. Britain was particularly successful in ridding itself of an inefficient public sector through active privatisation and regulatory innovations such as unbundling of sectors like electricity to marketise some segments, while using incentive rather than cost plus regulation. Privatisation became an important aspect of structural adjustment of many countries. In most countries given the vast inefficiencies in the public sector, efficiency stood to gain wherever there was a capable private sector or foreign firms could supply the service.

**In the project countries, structural adjustments, privatisation and liberal FDI policies have resulted in large FDI flows**, particularly in the services sector. Privatisation has been one of the most important causes of FDI in recent years. Among the project countries, except in India and Bangladesh, privatisation has been quite significant and has resulted in private flows especially foreign. **In all project countries cross-border M&A activity has enhanced the privatisation process, Bangladesh being the only exception**. There is also no doubt that FDI is crucial to globalisation of the services sector, it being one of the most important among non-tradable sectors.

Besides, in many of the project countries, post adjustment, fiscal stability seems to have been achieved at the expense of compressing public expenditure at a time when public services are either

deteriorating or are not growing rapidly enough. A tight monetary policy may have been good for controlling inflation but may have reduced investment through a credit squeeze. Slower rates of investment often result in lower FDI inflows.

*Contributions of FDI and the Role of Large Fluctuations in Inflows*

Most importantly, the fluctuations that private capital inflows have imposed still need to be recognised. **It was shown that fluctuations in FDI flows into LDCs have been high**; countries with smaller volumes of FDI have experienced larger fluctuations in FDI inflows. **Significant dependence on FDI to bridge the investment gaps in such a scenario can be quite problematic**. A fact that is not generally admitted or even recognised is that in inward capital movements to LDCs that have typically followed growth or liberalisation on the capital account, or both, have after a while reversed in many cases. **Overall however, FDI can raise domestic investment, provide additional financing or achieve some combination of the two. This however is only possible givgen the 'correct' internal economic conditions.**

*Policies Should Focus on Removing Structural Constraints & Creating Regulatory Clarity*

**The experience of project countries suggests that market seeking has been the key driver for recent investments.** This is followed by natural resource seeking in the African countries and Bangladesh and in limited way efficiency seeking in countries like Brazil, Hungary, India and South Africa. **The policy focus should however be on efficiency improvement and market growth**. Besides, where resource-seeking possibilities exist, policy constraints for efficient utilisation of these resources by domestic and foreign entities are critical. Market seeking preferences are also met when countries are well integrated with the others in the region.

Apart from the two South Asian economies, India and Bangladesh, the other nations are rapidly getting integrated with the regional economic systems. While such integration can create potential for FDI inflows due to market creation, other features (e.g., skills, infrastructure etc) may be required to become a hub for FD investment to cater to local markets. *Prima facie*, while South Africa, Hungary and Brazil seem to be equipped to take on this role, Tanzania and Zambia are not very attractive in this respect. Role of infrastructure is critical even for countries like India and Bangladesh which are not yet a part of an integrated regional market where export intensive FDI can potentially be attracted. Thus, factors like infrastructure generate positive externalities for both market and efficiency seeking FDI.

**Overall, there is not much difference in the FDI specific policies adopted by the project countries. All countries have liberalised these policies to a higher or lower degree. Only marginal improvements may be necessary, as FDI policies are already liberal. Some of these have been highlighted in the context of specific countries in the last section.**

**In general, policy liberalisation on this front seems to be desirable, except for the full capital account convertibility. As of now capital account seems to be fully convertible only in Zambia. Tanzania plans to do so soon, while policies are very liberal in other countries, especially in South Africa. The move to full convertibility needs to be cautious and needs to be preceded by maturing of capital markets and establishment of regulatory structures.**

**Growth oriented policies with high rates of domestic investment will go a long way in attracting FDI. Since privatisation and infrastructure provision is critical in many respects,**

**regularity clarity is critical for attracting both domestic and foreign capital. In the absence of such clarity, investments may not flow in even where market/structural potential exists.**

## Conclusion and Policy recommendations

The civil society survey has shown that it is largely positively oriented towards FDI in all the countries studied. However, it does have certain specific concerns related to FDIs contribution to the economy. These concerns are reflected in its orientation towards having some constraints in the functioning of FDI firms. Civil society perceptions, it appears, have been shaped by a combination of the current economic climate of greater liberalization and openness in economic policy, and perhaps more importantly, on the actual experiences of their countries.

Consequently, studying the experiences across countries has two advantages. First, it allows us to better appreciate the concerns of civil society. And second, it enables us to draw important policy conclusions directly from specific experiences, rather than from abstract theories.

Civil society plays an important role in shaping public opinion in the long run. An understanding of what its perceptions are and how they are likely to evolve, will also better enable us to gauge public opinion. Inasmuch as public opinion shapes long term economic policy, it also allows us to gauge the directions in which policy is likely to evolve in a range of countries. In other words, sensible and sustainable policy is one that takes into consideration the ground realities of the sector and in the country. These 'realities' not only include the economic conditions and international business environment, but also public opinion.

The objective of this paper, as mentioned, is to recommend policy that is sensible, sustainable and will allow FDI to maximally contribute to the progress of the host countries. The experiences of specific sectors in the different countries have yielded a rich set of insights. We find certain policies that have a positive impact, those that have a negative impact, and another set that are not likely to have had any impact.

### Policy Recommendations

1. The governments should interact closely with civil society. This will (i) enable a better appreciation in the public of the many facets of policy formulation, and (ii) better enable the government to gauge public opinion.

2. Provide an enabling environment for better and more efficient economic activity. The enabling environment includes (i) education (ii) infrastructure (iii) good governance and crime. (*Indian software industry, Tourism in Zambia*)

3. Low government intervention allows private efforts to flourish, these could be through international firms or domestic entrepreneurial initiative (*Indian IT industry, Tourism and Agro-processing in Zambia*)

4. FDI contributes the most in an open environment; trade liberalization allows countries to maximize long term gains. However, in the short term countries should expect a negative impact on domestic industry (*Telecom in Brazil, Cement in Bangladesh*)

5. Openness in trade however is a two way street; if for instance Bangladesh were to open its borders to Indian cement imports, without an opening of India imports to (say) Bangladeshi textiles, then the gains will not occur. (*Cement in Bangladesh*)

6. Short run opportunities can be used to create long term strengths with the help of FDI (*RMG in Bangladesh*)

7. Even in the presence of infrastructure and ground-level constraints, a policy of openness to FDI can create economic strneths (*Zambian Agro-industry*)

8. The better marketing networks are a two-way street. While they offer high export opportunities, they also may lead to greater imports. However the net effect is likely to be positive. Trying to have dual policies – encouraging exports and limiting imports are not likely to yield long term gains (*Brazilian Telecom, South African Food and Beverages sector*).

9. Many inequalities remain in international trading arrangements, and these are strongest in the agriculture sector. These inequalities (such as limits on imports in developed countries, subsidization of developed country exports, etc.) negatively impact liberal policy formulation in developing countries. Developed countries would do well to appreciate that their dual policy of openness when it suits them and controls when it does not, not only harms their credibility, but also has strong negative impact on developing countries (*South African Food and Beverages sector*)

10. In some sectors such as in finance, good regulation is a necessary condition for not only FDI to be successful, but also sustainable growth. A government devoting more efforts towards good regulation is likely to yield more FDI than creating specific policies aimed at attracting FDI (*Financial sector in Tanzania*).

11. Gains from privatization have also been documented; but these gains are most when public sector monopolies are not converted into private sector monopolies. Breaking up large public sector organizations into more than one competing entities is a good route. (*Mining in Zambia*)

12. High level of incentives may attract FDI, but they also generate negative domestic concerns about the overall benefit of FDI. (*Mining in Tanzania*)

13. Complementary sectors and activities have to be functioning properly before FDI can be expected to make a strong positive impact. (*Power production and distribution in India, Telecom interconnectivity in Bangladesh*)

14. Advice from international experts should be taken, but it should also be in line with ground level realities. Civil society and domestic experts should be incorporated in policy formulation that is more in line with the conditions in a country. (*Power production in India*)

15. FDI has a positive impact across the economy, such as in complementary sectors. (*Tanzanian Telecom*)

16. Uncompetitive domestic base would tend to lose out in the presence of greater FDI All available evidence would support the view that economies are better served if reallocation of productive capacity towards more productive sectors occurs. Civil society should be able to appreciate that re-allocation of resources is an integral part of economic growth. (*Brazilian telecom manufacturing sector, South African Auto industry* )

17. Transfer pricing practices that limit host government abilities to gain tax revenues. These unethical (and sometimes illegal) activities also create a negative perception towards FDI in the eyes of civil society. Both developed and developing countries need to coordinate their activities to limit such practices. (*Brazilian Auto industry*)

18. If given a relatively free hand (not prevented by many rules and regulations) greater economic openness generates its own 'pull' for greater FDI, thereby benefiting all. In large markets merely opening up of the economy will lead to greater FDI (*Brazilian and Indian Auto industry*)

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