FDI in South Asia: Do Incentives Work?  
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Preface

Over the last two decades or so, along with trade barriers, countries around the world have progressively dismantled restrictions on foreign direct investment (FDI). Countries as diverse as China, Mexico, Brazil and India have progressively lowered barriers to entry in sector after sector to bring in new sources of capital, increase competition to spur productivity growth, and accelerate the pace of technological progress. UNCTAD research shows that between 1991 and 2001, a total of 1393 regulatory changes were introduced in national FDI regimes, of which 1315 (or approximately 95 percent) were in the direction of creating a more favourable environment for FDI. It is noteworthy that the vast majority of these changes were introduced autonomously rather than in the context of international negotiations.

Apart from the main objective of increasing investment through inflow of foreign capital, the positive externalities of FDI to the host country is the other important reason for countries competing against each other for foreign direct investment. The positive externalities, such as technology transfer, management skills, labour skills, etc. may spillover to local firms. Countries, in order to attract foreign investment, are offering generous incentive packages and justifying their actions with the productivity gains that are expected to accrue to domestic producers from knowledge generated by foreign affiliates.

Still, countries tend not to grant unrestricted rights of entry to all investors and to all types of investment. The main restrictions on FDI are centred in services, i.e., in finance, telecommunications, power, transport, ports, wholesale and retail trade, real estate, legal services and public utilities. Developing countries, in particular, impose restrictions on entry and operations of foreign firms in these sectors in order to maintain some control over the policy space.

The FDI policies of South Asian countries have also been on similar lines. The South Asian countries liberalised their FDI policies in the last decade of the previous century. The policy measures, which have been taken since then, include 100 percent equity for certain sectors (with some variation among the South Asian countries), automatic approval, incentives for export processing zones, national treatment, tax holidays, MIGA signatory, etc.

The moot question is, why, in spite of having a friendly FDI policy, the majority of developing countries so far have been unable to attract enough foreign investment? In fact, in South Asia (in particular in Bangladesh, Pakistan and Nepal), the inflow of FDI has actually declined in the recent past. Secondly, there is little conclusive evidence indicating that domestic firms benefit from foreign presence in their sector. Multinational corporations have been successfully preventing information leakage that would enhance the performance of their local
competitors in the same industry. Whatever little spill-over effect from FDI in the case of developing countries, it is mainly taking place through backward linkages, i.e., contacts between domestic suppliers of intermediate inputs and their multinational clients.

The present paper has looked at the understudied issues of FDI policies in South Asia, particularly from the point of view of the effectiveness of performance requirements imposed by host countries and the costs of accompanying incentives. The survey of theoretical literature on performance requirements indicates that a case can be made for imposing such requirements in South Asia, particularly from the welfare point of view. As regards the costs of incentives, which a country offers to foreign firms, so far only a few studies have tried to quantify them. These incentives are normally given as quid pro quo with performance requirements. But, in the bargain, it has been found, these incentives tend to be particularly costly over a period of time.

Jaipur, India

Bipul Chatterjee
Director
One of the dominant issues in the last century has been the increasing role of transnational corporations (TNCs) in trade relations. Thus, while flows of funds between TNCs grew much faster than world trade, TNCs and their affiliates now control more than 60 percent of world trade and production. The dominance of these TNCs has gone along with a decline in the flows of official aid. This has reflected in the general feeling among developed countries that aid flows distort country preferences. In addition, given their political implications, international aid flows lost some of their relevance after the end of the Cold War in the early nineties.

On the demand side, many developing countries liberalised at a frenetic pace in the previous decade. With changes in the Central Asian republics after the decline of the Soviet dominance, these countries have also been liberalising their FDI (foreign direct investment) policies partly to foster growth but also to hasten the conditions necessary to gain entry into the ever-expanding European Union. The net impact has been a fast paced and competitive liberalising of FDI policies in most developing countries.

This worldwide competition for FDI is reflected in the fact that in the period 1991-2000, about 95 percent of all changes in polices were favourable to FDI (see, for example, Nunnenkamp et al, 2003; World Investment Report, 2002). Thus, for example, in 2001, 208 changes in FDI laws were made by 71 countries aiming to make the investment climate more favourable to inward FDI (World Investment Report, 2002, p. xv). At the same time countries were signing up a multitude of bilateral investment treaties (BITs with the objective of ensuring protection and promotion of FDI [World Bank, 2003]).

Some of these liberalising initiatives have followed the compulsions of the regional trading initiatives under Article XXIV of the GATT (General Agreement on Tariffs and Trade). Thus, while Mexico and Latin America have gone much further in FDI initiatives under the influence of NAFTA (North American Free Trade Agreement) and the proposed FTAA (Free Trade Area of the Americas), even the normally conservative and staid ASEAN (Association of South East Asian Nations) countries have proposed some significant changes in their FDI regimes. Closer to home, countries of South Asia have also liberalised their regimes in significant ways.

In this competitive liberalisation, both developing and developed countries have used a combination of incentives and regulations to channel FDI into desired geographical areas or specific industrial sectors. It was precisely some of the regulations imposed that led to the demand for an imposition of constraints on FDI policies. In the
Uruguay Round of the GATT, this demand led to the formulation of agreements like the TRIPs (trade-related aspects of intellectual property rights) and TRIMs (trade-related investment measures).

In addition, the GATS (General Agreement on Trade in Services) agreement of the WTO (World Trade Organisation) also envisages some restrictions on regulations permissible in FDI policies. Following the Singapore ministerial meeting of the WTO in 1996, the European Union (EU), in particular, has been pushing still more for a general agreement, covering cross border flows of investment, along the lines of the GATT for commodities. In the run up to the Cancun ministerial meeting of the WTO, developed countries (the EU in particular) have demanded a more general multilateral agreement on investment on the grounds that this creates transparency in investment regimes, which is particularly important for small investors. Developing countries, on the other hand, have argued that a multilateral regime ties their hands in that it does not allow them to build-in developmental regulations that vary with the stage of development of the country.

Although FDI incentives are often motivated by macroeconomic problems, such as low growth rate and rising unemployment, in the host country (Blomström and Kokko, 2002), the strongest justification comes from the prospects of knowledge spillovers to the local firms. Since the foreign TNCs will not include these spillovers in the assessment of private costs and benefits, there arises a divergence of private and social benefits of foreign investment, which would be less than what should be considered socially optimum. The motive for incentives, to foreign investors, is to bridge the gap between private and social return, thus promoting larger inflows of FDI.

In developed countries, where most incentives are financial in nature, the subsidies per FDI-related job are thousands of US dollars (World Investment Report, 1995). While, in the pre-globalisation period, the effect of FDI incentives was generally downplayed, the TNC executives now openly admit their importance in investment decisions (Easson, 2001). Econometric studies on effects of FDI incentives are practically non-existent. But two recent studies, Clark (2000) and Taylor (2000), seem to suggest that incentives are significant determinants of direct investment flows, while earlier studies found small or no effects of incentives.

Even if one assumes that FDI incentives attract larger investment flows, the empirical evidence, particularly with respect to countries in South Asia, is scarce. It is not obvious that they are also efficient, i.e., their benefits are at least as large as the costs of incentives. Also, the local firms may not possess the ability and motivation to engage in investment and learning to absorb foreign knowledge and skills for which the host government pays heavily in terms of incentives it offers. This is precisely the reason why several authors draw a parallel between trade barrier and international investment subsidies and even talk about tariff equivalents for each FDI subsidy (Bond and Guisinger, 1985; Huizinga, 1991). All this suggests that incentives should not be of an ex ante type, granted prior to investment. Rather, the incentives should be combined with...
performance requirement to ensure that potential benefits in terms of spillover, export performance, or forward and backward linkages are realised.

This paper has looked at the issue of FDI policies in South Asia, particularly from the point of view of the effectiveness of performance requirements imposed by the countries of South Asia, and the costs of the accompanying incentives. The objective is limited to mainly doing a brief survey of the existing theoretical and empirical literature with, as far as possible, specific reference to South Asian economies. Chapter 2 summarises the FDI policies of the South Asian countries India, Pakistan, Sri Lanka, Bangladesh and Nepal. The focus is on emphasising the incentives built into the FDI policy over time. Chapter 3 then surveys the theoretical literature on performance requirements and incentives. This is followed in Chapter 4 by a brief survey of the TRIMs compatibility of incentives by the South Asian countries. Chapter 5 surveys the existing literature on the costs and benefits of incentives to FDI, particularly from the point of view of the South Asian economies. Finally, in Chapter 6 (conclusions), some tentative broad generalisations are offered.
Chapter 2

FDI Policies in South Asia

As argued in the introductory chapter, South Asian countries began their own phase of liberalisation of FDI policies in the last decade of the previous century. Given their close proximity, it was clear that a highly restrictive FDI policy in a country would result in little FDI inflows into that country. In South Asia it is also clear that while the lure of the domestic market has been largely the attraction for FDI into India, for smaller countries like Sri Lanka and Bangladesh, access to export sectors on attractive terms would be the primary motivation of FDI. The geographical proximity of these countries also implies that the widely divergent FDI policies would not be sustainable as this would lead to country-hopping by foreign investors.

In the accompanying table, the FDI policies of these countries have been presented for easy comparability. It summarises various aspects of the FDI policies in five South Asian countries but hides important details, which should be mentioned for a useful analysis. What follows is a brief country-wise pattern of the FDI policies, performance requirements and incentives.

India

Unlike the other countries of South Asia, India's FDI policy dates back to 1950. However, till 1980 or so, the FDI policy operated in a negative way, in the sense that the objective was more to restrict than to create any incentives for new FDI (Martinussen, 1988). However, starting from the Technology Policy Statement of 1982, India's FDI policy has progressed towards greater and greater liberalisation (see, for details, Pant, 1995). The year 1991-92 is a watershed in that many of the liberalisation initiatives of earlier years were codified in the Industrial Policy of 1991.

Starting from 1991, the FDI policy has consisted of specifying a few sectors (the negative list) where FDI is not permitted. There are three demarcated areas: the banned sectors, those sectors where automatic FDI is permitted up to 51 percent foreign equity, and those where approval is required of the Foreign Investment Promotion Board (now renamed the Foreign Investment Implementation Agency). Since 1991, the incentives have taken a number of forms. For one, the 51 percent foreign ownership has been extended mainly to export oriented sectors, infrastructure sectors and sectors involving electronic commerce.

In the case of 100 percent foreign ownership, the condition is that if the company is also listed outside India, it must divest 26 percent of equity in favour of Indian industries after a period of five years. This last stipulation is specifically applied to telecommunication,
trading and marketing of petroleum products, and other trading (business to business and e-commerce). It may be noted that an export incentive (unless it is a prohibited production subsidy) is not TRIMs violative unless it is firm or ownership specific. On the other hand, an income tax holiday targeted at exporting firms is prohibited.

A second incentive was part of the Industrial Policy of 1991: the de-linking of equity and technical collaborations. Hence, a foreign collaboration does not need a foreign technical transfer component. This was a major departure from the strict technology regulations of the eighties, whereby foreign collaborations which did not involve a technical component were strongly discouraged (see, for a detailed discussion, Pant, 1995, Ch. 3). Since 1995, a number of liberalising initiatives have been taken, ranging from limited (non-resident Indians) entry of FDI into reserved small-scale sectors. Even this can be relaxed in the case of foreign ventures, which undertake to export at least 50 percent of their output.

Finally, the FIPB, in principle, also grants approval to FDI in the consumer goods sectors (barring agriculture) on a case by case basis, which is normally done expeditiously. The experience of the last few years indicates that barring agriculture, retail trade and sectors reserved for the small-scale sectors, foreign equity even in consumer goods sectors is welcomed.

In general, most foreign companies have access to all the sectoral and regional subsidies applicable to purely Indian companies. More recently, many foreign firms are being given permission for acquiring Indian companies where the takeover is not seen to be predatory. In addition, most of the states have been creating single windows for clearing up FDI applications on a priority basis. Finally, India has now removed all the TRIMs' inconsistent regulations like local content and export obligations, even in sectors like automobiles.

Pakistan

In Pakistan, foreign investors can acquire 100 percent equity without prior permission from the government, and the amount of foreign equity investment shall be at least US$0.5mn. The major sectors that have been opened up are manufacturing, power generation, telecommunication, highways' construction, port development and operation, oil and gas, infrastructure, social and agricultural sectors. The salient features of Pakistan's foreign investment policy in 1997 were:

- relaxation of foreign exchange control;
- provision of full safeguards to protect foreign investment;
- withdrawal of work permit restrictions on foreign managers and technical personnel; and
- abolition of ceilings on royalties, technical fees and foreign private loans.

Pakistan has a local content policy, known as deletion policy, and the ministry of industries monitors the deletion schedule and approves all deviations from policy. Incentives offered are industry specific. For instance, in engineering goods, imported machinery and
Incentives are offered to Free Industrial Zones (where a variety of exportable products are manufactured), Free Trade Zones (created to boost export trade) and Export Oriented Units (exporting their entire production excluding a limited amount of domestic tariff area sales). Among the main incentives are import duty and provincial tax exemption on imported machinery and raw material and project financing from local district financial institutions and banks. In addition, the government has set up export processing zones in Karachi, Sialkot and Rawalpindi, where the units are completely exempt from federal, provincial and municipal taxes, as well as from foreign exchange control and insurance regulations. EPZs also offer 100 percent ownership rights, full repatriation of capital and profits and tax exemption on income accruing outside Pakistan.

Nepal


The government encourages 100 percent foreign owned enterprises and joint ventures with Nepalese investors. The sectors that have been opened up for foreign investment are manufacturing, energy-based industries, tourism, mineral resource based industries, agro-based industries and services. There is also a list of sectors, such as cottage industries, arms and ammunitions etc. where foreign investment is not allowed. There is no system of automatic approval of foreign investment projects and the Industrial Promotion Board approves all proposals that meet the criteria laid down in Nepal's industrial policy. Foreign investors are permitted to repatriate all profits and dividends, royalty payments etc., subject to approval of National Rashtra Bank and Department of Industries. Foreign technical personnel are allowed, but the industry has to train Nepalese counterparts along with foreign experts. Foreign experts are allowed to repatriate 75 percent of their earnings.

Foreign investors are also guaranteed against non-commercial risks such as currency transfer, expropriation, breach of contract, and war and civil disturbance under Multilateral Investment Guarantee Agency (MIGA). There are no performance requirements related to...
<table>
<thead>
<tr>
<th>Restricted Sectors</th>
<th>INDIA</th>
<th>PAKISTAN</th>
<th>NEPAL</th>
<th>SRILANKA</th>
<th>BANGLADESH</th>
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<tr>
<td>i. Arms &amp; ammunitions</td>
<td>i. Arms &amp; ammunitions</td>
<td>i. Cottage industries</td>
<td>i. Non bank money lending</td>
<td>i. Arms &amp; ammunitions</td>
<td></td>
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<tr>
<td>ii. Defence aircrafts &amp; warships</td>
<td>ii. High explosives</td>
<td>ii. Personal business services</td>
<td>ii. Pawn broking</td>
<td>ii. Production of nuclear energy</td>
<td></td>
</tr>
<tr>
<td>iii. Atomic energy</td>
<td>iii. Radio active substances</td>
<td>iii. Security printing, currency &amp; mint</td>
<td>iii. Retail trade with a capital investment of less than $1 million</td>
<td>iii. Security printing &amp; minting</td>
<td></td>
</tr>
<tr>
<td>iv. Railways</td>
<td>iv. Security printing, currency &amp; mint</td>
<td>iv. Arms &amp; ammunitions</td>
<td>v. Forestry in the reserved forest areas</td>
<td>iv. Forestry in the reserved forest areas</td>
<td></td>
</tr>
</tbody>
</table>

| 100% equity | Only for certain sectors, sectoral caps exist | Yes, for all sectors | Yes, except restricted sectors such as telecom, education, mass transportation, mining, etc. | Yes |
| Incentives | Yes, central government gives for R&D measures, State govt. give wide variety of incentives | Incentives are industry specific but has local content requirement | Yes, with export requirement and local content requirement | Yes. It varies depending upon the location of industries. |
| Restrictions in royalty or technology transfer payments | No, but certain minimum conditions to be met such as lumpsum payments not exceeding US $2 million etc. | No | No | No. The condition is that it should not exceed 6% of previous year's sales. |
| Performance requirements | Yes, specific rules for automobile sectors | No. (only for eligibility of incentives) | No. (only for eligibility of incentives) | No. (only for eligibility of incentives) | No |
| EPZ incentives | Yes | Yes, complete exemption of taxation from federal, provincial & municipal bodies | No | No. Industrial Processing Zones for better land allocation. | Yes |
| Automatic Approval | Yes, by RBI | Yes | No. Approval is given by Industrial Promotion Board (IBP) | Yes, by Board of Investment (BOI) | Yes, by BOI & BEPZ authority |
| National treatment | Yes | Yes | Contract terms are given precedence over Nepali law in investments valued at more than Nepali Rupees 500 million | Yes | Yes |
| MIGA signatory | Yes | Yes | Yes | Yes | Yes |
| Tax holidays | Yes | Yes | Yes | Income earned from exports is free from income tax | Yes |

Foreign Investment Policies of South Asia
local content, export obligation etc., but there are incentives for industries engaged in export trade and using local raw materials. Some of these incentives are:

- no income tax on export income;
- no tax on a foreign investor's interest income earned abroad;
- a 15 percent tax on income earned from foreign technical and management service fees and royalty;
- a 10 percent tax exemption for industries, other than hazardous industries, using 80 percent or more domestic raw materials and employing all manpower locally; and
- customs duty and sales tax reimbursement within 60 days for industries selling products to Export Promotion House.

Sri Lanka
The Board of Investment of Sri Lanka provides all services for foreign investors, including approval of projects, grant of licenses and tax incentives etc. Foreign investment is mainly encouraged in enterprises with extensive use of foreign capital or technology, in export oriented industries and in infrastructure projects. In many sectors, automatic approval is given for equity participation up to 100 percent.

For the restricted sectors, such as telecommunication, education, mass transport, mining etc., permits are required from other government agencies for more than 49 percent equity participation. There is no exchange control on current account transactions and no barrier on remittance of corporate profits and dividends for foreign enterprises. Sri Lanka is a founder member of MIGA (Multilateral Investment Guarantee Agency of the World Bank). Intellectual property matters come under the Intellectual Property Act of 1979 under which all trademarks, designs and patents must be registered with the Registry of Patents and Trademarks.

As regards performance requirements, the general condition is that the manufacturing enterprise has to export 80 percent of output while the service sector has to export 70 percent of its output, with required minimum investment and employment levels to qualify for preferential incentives which vary across sectors. Incentives to investment vary across sectors with specified minimum investment requirements and there is no discrimination between domestic and foreign investors. The incentives are mostly in the form of tax holidays of 5 to 20 years, followed by a preferential tax rate of 15 percent.

Bangladesh
The Board of Investment and Bangladesh Export Processing Zone are the two authorities that deal with foreign investment proposals, welcoming FDI with 100 percent ownership or joint ventures with private or public sector industries in Bangladesh. There is no exchange control on current account transactions and repatriation of capital and returns from investment. Adequate intellectual property protection is available and no prior permission is necessary for agreements involving payment of royalties, fees etc., provided that the total fees and expenses connected with technology transfer should not exceed six percent of the previous year's sales of the enterprise, as declared in the tax return or six percent of the cost of imported machinery, in the case of new projects.
Special incentives are provided for investment by Non-resident Bangladeshis, for whom a quota of ten percent has been fixed in primary public shares. Apart from this facility extended to NRBs (non-resident Bangladeshis), there is no discrimination between the foreign and Bangladeshi investors. The incentives for foreign investment are in the form of tax holidays of five to ten years from the commencement of commercial production. Industries not under the scheme of tax holidays are eligible for accelerated depreciation allowance at 100 percent of the cost of machinery or plant located within a radius of ten miles from the municipal limits of some major cities, like Dhaka and Chittagong. A wide variety of incentives are offered to industries in the Export Processing Zones, such as full duty drawback on imported raw materials used for manufactured exports, with at least 25 percent domestic content, a ten-year tax holiday, offshore banking facility, exemption from local taxes and national policy restrictions.

The attractiveness of Bangladesh as an FDI destination is aided by the fact that there are no trade union activities. In addition, approval of any project in the EPZs includes all infrastructural and service facilities readily available at the door of the project site.
Chapter 3
Performance Requirements

One of the most contentious issues is that of performance requirements imposed by developing countries on FDI. In general, the objective of performance requirements is primarily to direct FDI into serving specified development objectives. While the objectives may be varied, it is possible to group these performance requirements into three categories: those relating to export performance, those relating to local content requirements and those relating to technology transfer. While the first has been guided largely with the consideration of paying for imports in a liberalised environment, the last objective is guided mainly by the understanding that left to themselves, TNCs have no incentive to upgrade technical knowledge in developing countries. Finally, the issue of local content requirements is mainly in the context of raw materials and employment, the objective being to ensure local spin-offs from operations of TNCs.

In the following section, theoretical arguments on performance requirements has been reviewed, before coming to the empirical issues.

Exports and FDI
In the 1980s, in particular, the most common performance requirement imposed on FDI was a minimum export commitment. This was particularly true in the case of FDI policies of developing countries including those of South Asia. A survey of the US Department of Commerce (1981) noted that about 30 percent of US affiliates located abroad were subject to one or more performance requirements. For most countries, there is, in a sense, no tie-up between export incentives and foreign direct investment. That is, exports are promoted regardless of ownership. In the end, however, because there are incentives to be gained by exporting, FDI would be relatively more attracted to exporting activity. The literature on the theoretical impact of export requirements centres around how the benchmark for evaluation of welfare increases is measured. If one calculates welfare increases against the benchmark of a perfectly competitive free-trade scenario, there is no doubt that export restrictions would be welfare reducing as they impose a welfare reducing distortion into the market for traded goods (Batra, 1972; Herander and Thomas, 1986; Safarian, 1983).

However, it has been argued by Rodrik (1987) that sectors in which performance requirements have been imposed are transportation equipment, chemicals and machinery, where the prevailing market form is oligopoly. As argued by Rodrik, if the benchmark is the second best one of oligopoly, then one cannot automatically conclude that export performance requirements are welfare reducing.
In another paper, Brecher et al. (1977) have shown that capital inflow can be welfare reducing for a protected economy if imports are capital intensive and the host country is incompletely specialised. The general principle is drawn from the well known theory of trade under economic distortions. If the export restriction increases the output of the unprotected (non-import) sector, then it tends to counter the welfare reducing effect of the distortion and welfare could increase. In general, oligopoly creates a second best situation where export restriction could be welfare improving (see, Rodrik, op cit).

Another set of studies looks at the issue of exports and FDI from a strategic point of view. A firm serving foreign markets has many options, including the choice between exports and FDI. While economic theory suggests substitution between exports and FDI, most empirical studies, such as Lipsey and Weiss (1981, 1984), Graham and Mutti (1991) and Blomström et al. (1994) claim that there is a complementary relationship between trade and FDI. There is, however, no conflict between theory and empirical evidence as Blonigen’s (1999) work shows that export of intermediate goods and sales of affiliates are complements, whereas exports and sales of final goods are substitutes.

Strategic considerations are also important as Bhagwati et al. (1987, 1992) have argued that a threat of future trade restrictions may drive in anticipatory foreign investment. The theoretical framework of Horstman and Markusen (1992), Norman and Motta (1993) and Motta and Norman (1996) has more such strategic elements. For instance, when two firms are exporting to a foreign market, a switch from exports to FDI by one firm may create an incentive for FDI for the other.

Lin and Saggi (1999) call this the competitive incentive for FDI. Dynamic elements are highlighted by Roberts and Tybout (1997) who regard exports and FDI as representing two different cost technologies: the former having higher marginal cost but lower sunk cost than the latter. In a two-period model of choice between exports and FDI under demand uncertainty, Saggi (1997) has shown that a firm may export in the first period and switch to FDI in the second period if the market size turns out to be large. Uncertainty or imperfect information influences a firm’s investment decisions. Kinoshita and Mody (1997) suggest that operational conditions, such as functioning of labour markets, literacy, productivity of labour force, input quality etc., are important elements in the information set of a firm, as well as its competitors.

**FDI and Local Content Requirements**

As in the case of exports, considering the welfare impact of local content requirements is meaningful only when considered against the benchmark of a second-best situation. In the literature, the imperfections considered are oligopolistic markets for final goods and/or raw materials. Surprisingly, there is little theoretical literature dealing with local content requirements on labour, even though this has been an important part of FDI policies of countries like Malaysia and China (Pant, 1995). Presumably, the case of labour is considered as symmetric to that of other inputs.
The issue of local content legislation has been considered by Grossman (1981), Davidson et al. (1987) and others, in a series of papers in the 1980s. However, as pointed out by Richardson (1991), if the foreign input is cheaper than the domestic, local content legislation will be ineffective, unless there is a prohibitive tariff. The logic is that, in the absence of this tariff, the TNC will switch from producing in the host country to supplying the country through exports. The case of domestic and foreign inputs being imperfect substitutes is considered in Mussa (1984). The case of oligopoly, in both the final goods and input markets, is the subject matter of Vousden (1987), while both the domestic and foreign firms produce the input in Krishna and Itoh (1986).

As argued cogently by Richardson (op. cit.) the final welfare impacts seem to rest on the effect of the local content legislation on profits of foreign and domestic final goods producers, as well as the profits of domestic input producers. In general, local content legislation may reduce profits of domestic producers by raising input costs and reducing output. Anyhow, the profits of domestic input producers may increase sufficiently to raise overall welfare. Further, if there is a small “local content” requirement, the foreign producer, in fact, increases his input use as he behaves like a Stackelberg leader in the input market. Hence, even the foreign producers' profits could increase.

Usually, the effects of a local content legislation hinge entirely on the existence of an imperfect market structure (Cournot-Nash rivalries) and profit-shifting between producers (see also Salop and Scheffman, 1983; Hollander, 1987). The essential premise is that in any Cournot oligopoly, input use is less than socially optimal, as producers do not account for the impact of their input purchases on other producers. A local content legislation, if it increases local input use, may counter this negative by bringing input use closer to the social optimum.

**FDI and Technology Transfer**

TNCs have a choice between licensing, joint venture and FDI. While technology licensing is a market based alternative, joint venture and FDI are mechanisms to internalise technology transfer. Markusen (1995) and Caves et al. (1983) have extensively discussed this internalisation issue. In the “knowledge capital” model of Markusen and Maskus (1999), innovation, having the non-rival property of public goods, can be applied in multiple plant locations spread all over the world, giving rise to horizontal multinational firms. The TNCs may prefer direct entry (FDI) to joint venture or licensing due to the apprehension that the joint venture partner or the licensee will have no interest in preventing dissipation of knowledge capital.

In another set of papers, Ethier and Markusen (1991), Markusen (1999) and Saggi (1996,1999) seem to suggest that such dissipation of knowledge will increase competition, which reduces TNC profits. There is some empirical support behind this hypothesis. Smarzynska (1999a) has found negative correlation of a firm's R&D spending with the probability of a joint venture, but positive correlation with greenfield entry. However, Horstmann and Markusen (1996) have
argued that the TNC’s initial entry into the host country may be in the form of licensing the technology to a local agent, due to high sunk costs of direct involvement, which, after some time, is outweighed by agency costs, i.e., the costs of monitoring the agent’s activities which include the tendency on the part of the agent to use better knowledge of local conditions for extracting rent.

The next sets of issues we take up in this study are related to FDI, technology transfer and spillovers. It is perhaps not possible to claim that FDI is the main channel of technology transfer. World Investment Report (1997) shows that in 1995 over 80 percent of royalty payments for international technology transfers were made from subsidiaries to their parent firms. But, this does not include technology transfers via imitation (spillover) and trade in goods. Demonstration effect is regarded as a strong force behind technology adoption. In the absence of FDI, the local firm has no idea as to what a new technology is capable of and may find it prohibitively costly to acquire this information. The TNCs demonstrate the success of a new technology that the local firm may later adopt. Parente and Prescott (1994) show that trade may lower the cost of technology adoption by exposing the local firms to new products. Even though FDI expands the set of information that the local firms have, it also brings more competition, which makes technology adoption less profitable, making the net effect of FDI rather uncertain. In this context, another important issue is the decision of the foreign firm regarding direct entry versus total or partial acquisition of local firms.

A paper by Mattoo et al. (2001) shows that the foreign firm’s mode of entry affects both the extent of technology transfer and the degree of competition in the host country. Their result suggests that direct entry is preferred if the cost of technology transfer is very high. The host government would, after all, prefer acquisition, as it results in a larger technology transfer, the benefits of which may outweigh its anti-competitive effects and would prefer direct entry if the cost of technology transfer is low. In the former case, the host government would put restrictions on direct entry of the TNCs, and, in the latter case, offer incentives on acquisitions and joint ventures.

Technology transfer or spillover from foreign investment is neither guaranteed, automatic or free. Spillover is difficult if the technology gap between foreign and local firms is too large (Kokko, 1996; Sjöholm, 1997; and Blomström and Kokko, 1998). Joint venture is generally regarded to have greater potential for technology transfer, particularly if the foreign firm owns the majority shares (Ramachandran, 1993), but much depends on whether synergy operates between foreign and local firms, with the latter being better endowed with the knowledge of local conditions than the foreign partner (Blomström and Zejan, 1991). The size of FDI flow seems to be one of the crucial determinants of its effects on the host economy. Markusen and Venables (1997) have shown that if the FDI flow is sufficiently large, it creates strong forward and backward linkages, though some local producers lose out in competition. In a theoretical model they have shown that under certain conditions, FDI may act as a catalyst for industrial development in the host country.
The quality of the technology that is transferred by the TNC to the local firm in a less developed country has been considered uncertain in a large number of studies. Marjit (1989) and Rockett (1990) have shown that when there is a possibility of imitation, the TNC may license an older technology, reducing the value of the technology; but a lot depends on the nature of competition in the product market where the TNC and the local firm are either Cournot-competitors or Bertrand-competitors. In the latter case, the best technology never gets transferred. However, as Kabiraj and Marjit (1993) have demonstrated, the host-country government can induce the foreign firm to transfer the best technology by designing a suitable payment policy.

Technology transfer or spillover issues are very closely linked with the intellectual property protection regime (Mansfield, 1994). Technology has some characteristics of a public good, namely non-rivalry (its use by one person does not decrease the quantity available for another person) and non-excludability (it may not be possible to prevent people from making unauthorised use of a technology that is embodied in the product). Spillover is the result of these two characters of a technology and an inventor is concerned about the loss of intellectual property that takes place. But Helpman (1993) argues that if IPR protection is made globally stronger to make imitation difficult, developing countries lose, but the industrial countries that are innovators, also lose because the innovation race to beat the imitators stops and global innovation rate slows down. Glass and Saggi (1995) have argued that imitation reduces the cost of the innovator who has to adjust the invented technology so that it suits the local requirements. But, there are opponents of this view. For instance, Vishwarao (1994) has shown in a game theoretic model that lack of patent protection can only bring in high cost technologies in the South.

**TRIMs: Case of South Asia**

The interest in performance requirements demonstrated in theoretical work in trade theory in the 1980s translated itself into practical application in the discussions lead up to the Uruguay round agreement. As we have seen earlier, the last decade of the previous century saw a major movement of FDI into the developing countries. So much so that, in the first half of the previous decade, FDI inflows into developing countries started accounting for about half of total worldwide flows of FDI (Nunnemkamp et al., 2003). Investors, particularly in developed countries, attempted to reduce the restrictions on FDI in developing countries through a series of bilateral agreements. This led to the adoption of the Agreement on Trade-related Investment Measures (TRIMs) as part of the Uruguay Round agreement, establishing the WTO on 1st January 1995.

It may be noted that TRIMs legally applies only to trade in manufactures. Nevertheless, since the mid-1990s, service trade has overtaken manufactures in importance. Today, elements of TRIMs are likely to be found in the General Agreement on Trade in Services (GATS) and in the current demand by developed countries for a multilateral agreement on investment (Pant, 2003; Nunnemkamp et al., 2003).
As a general rule, the objective of TRIMs was to eliminate restrictions on foreign investment which violated Article III (National Treatment) and Article XI (Elimination of Quantitative Restrictions) of the GATT. For this reason, signatories of GATT were required to first notify all existing violations under Article 5.1 of TRIMs and phase them out in the next five years (for developing countries) or seven years (for least developed countries). The WTO’s Council for Trade in Goods would undertake a review of TRIMs inconsistent provisions after five years. Moreover, members could maintain TRIMs inconsistent measures for balance of payments consideration or if they had applied for and got permission to continue notified TRIMs inconsistent measures.

In line with the general requirements of TRIMs, two of the South Asian countries under review submitted the list of TRIMs inconsistent measures in force in 1995. In the case of India, the three measures, which were notified, are:

- the requirement of dividend balancing in the case of 22 consumer goods industries;
- mixing requirement in the case of newsprint and certain pharmaceutical products like penicillin and intermediates of Rifampicin; and
- local content requirements and export obligations in the case of the automobile industry, as per automobile policy of December, 1997.

Pakistan notified its local content legislation, called the Indigenisation/Deletion Policy encompassing the engineering, electrical and automobile industries. However, the programme was not compulsory, but firms going in for the programme of indigenisation were entitled to import at concessionary tariffs. No phasing out of the programme was indicated in the original application under Article 5.1 of TRIMs.

Sri Lanka, in its notification dated 14th March 2000, has indicated that it has no TRIMs inconsistent measures. Subsequently, India has withdrawn all its TRIMS inconsistent legislations. Pakistan still has its measure in place, while Bangladesh did not notify any TRIMs inconsistent measure for removal. Pakistan has asked for a seven year extension for its notified TRIMs inconsistent measure beyond 1st January 2001 (see, WTO, Trade Policy Directorate, August, 2001). However, very few of the notified TRIMs inconsistent measures remain in force at present.

Typically, developing countries have petitioned for a general extension rather than the current system of individual requests for extension of TRIMs. This is part of the discussion of implementation problems in the context of the Doha agreement.

Performance Requirements and Incentives: Survey of the Empirical Literature

In the above section, the theoretical literature on welfare implications of performance requirements was looked at. The general presumption seems to be that starting from an oligopolistic situation, performance requirements may lead to a welfare increase. How effective
performance requirements are, will thus depend on the empirical reality. In addition, it has been seen that performance requirements are generally accompanied by granting of incentives to FDI. Some authors have argued that the cost of these incentives may be higher than the benefits of performance requirements (see Nunnemkamp, op. cit.).

In this section, survey of the empirical literature on performance requirements is done, before looking at the issue of incentives. While the attempt is to focus on South Asia, it should be made clear that studies (on incentives in particular) for South Asia have been few and far between. Given the concentration of FDI in Latin America and South East Asia, empirical literature has also focussed on these regions.

Export Performance Requirements

In analysing the issue of export performance, most of the earlier research looked at the relative outward orientation (share of exports to sales) of TNCs and local firms. Ordinarily, the studies found no significant difference in the export intensities (see Natke and Newfarmer, 1985, for Brazil; Morgenstern and Muller, 1976, for ten Latin American countries; Lim, 1976 and Reidel, 1975, for South East Asia). A study for Mexico by Jenkin (1977) found a superior performance for local firms only in the traditional and intermediate goods sectors. On the other hand, Willmore (1976, 1986) for Latin America and Lall & Mohammed (1983) found TNC export performance relatively superior to that of local firms. While for India, studies by Kumar (1990) and Pant (1995) find no statistical difference in the export performance of TNCs and domestic firms. More recent studies also found little relation between TNCs and export performance (see, IIFT, 2002). As argued in Pant (1995), the answer seems to be that export performance is a function of domestic policy, industry-specific factors and market competition rather than of transnationality per se. This is also clear in comparing the export performance of TNCs in Latin America and South Asia (see Pant, 1995, Chap. 2).

More recently, the issue of export performance has been looked at from the point of view of TRIMS and its effectiveness. It has been argued that export performance requirements induce TNCs to help the host country integrate into the world economy (see Kumar, 2003). By and large, the arguments are couched in terms of performance requirements, including local content requirements and technology transfer. The argument seems to be that these performance requirements enable developing countries to tailor the operations of TNCs to their own developmental objectives. Some authors have argued in favour of performance requirements in that all developed countries aggressively imposed performance requirements till quite recently (see, Cheng, 2002; Safarian, 2002; Low and Subramaniam, 1996). Again, Kumar and Singh (2002) argue that it was the existence of local content requirements that enabled TNCs like Ford and General Motors to meet their export requirements.

The presumption seems to be that, in the absence of these performance requirements, the actual behaviour of TNCs would be detrimental to host country welfare. Anyhow, what these studies seem to do is an
empirical testing of the well known theoretical argument (see above) that, in the absence of perfect competition in trade, a distortionary TRIMs policy may, in fact, increase welfare. Yet, this does not necessarily prove the optimality or desirability of a performance requirement. This issue will be dealt with in more detail, when one looks at the costs of incentives, particularly to developing countries.

Local Content Requirements

While export requirements are an attempt to force integration of the host countries with the world economy, local content requirements (LCRs) are generally imposed to ensure backward integration in the host economy and spinoffs to local producers of final goods or raw materials. As a rule, the objective is to counter the “sourcing rigidity” of TNCs: they tend to source their inputs from the parent corporations. It has been argued that this is due to the need to manipulate prices to evade taxes via transfer pricing (see Pant, 1993). This “sourcing rigidity” implies that there are limited domestic external economies for the host country industries (see Lipsey, 1998; Manifold, 1997; Kumar, 2003).

As commented by many authors (see Sercovich, 1998; Pursell, 1999), developed countries have, in the past, generally imposed such LCRs. More recently, the “rules of origin” clauses of Regional Trading Arrangements (RTAs) seem to work in the same way and no explicit LCRs are needed (see Kumar, 2002). Some authors have argued that these “rules of origin” clauses have more to do with increased FDI in some countries like Mexico than any specific government policies (see Nunnenkamp, 2003). By and large, some authors have argued that many developed countries now impose performance requirements under different rules that do not make them TRIMs inconsistent (see Moran, 1998; Belderboss, 1997).

The empirical literature on LCRs is surprisingly less prolific on employment issues which are of particular significance to developing countries. Some developing countries like Brazil and Malaysia have, after all, used local employment incentives in their FDI policies (see, for a detailed discussion, Pant, 1995, Chapter 2).

Technology Transfer and R&D: FDI and Spillovers

The positive externalities of FDI to the host country are the main reasons for countries competing against each other for foreign direct investments. The positive externalities, such as technology transfer, management skills, labour skills etc. may spillover to local firms. The important channels through which the spillovers may result in enhancing the productivity of firms are (Nunnenkamp, 2002):

- vertical linkages: the spillovers may occur when the local producers supply inputs to the multinational corporations (MNC) and also through the products offered by multinationals to the local buyers.
- horizontal linkages: the spillovers may occur between local firms and multinational corporations in an industry through demonstration effects by local firms in competitive markets.
- the spillover may also occur when local firms employ skilled workers from MNCs, thereby leading to increase in productivity level.
The experimental evidence on FDI spillovers shows mixed results. The practical studies also greatly differ from one another on the methodology used to study the effects of FDI on local firms. The existing literature on FDI spillovers is of three types (Smarzynska, 2002). They are:

- case studies which analyse the effects of FDI projects on specific countries or for specific industries;
- industry level studies, which examine the correlation between foreign presence and sectoral productivity; and
- firm level studies, which examine whether productivity of domestic firms is correlated with the extent of foreign presence in their sector or region.

The case studies, analysing the linkages between the multinational corporations and their local suppliers, have studied extensively the learning and technology transfer process as a basis for productivity spillovers (Blomstrom & Kokko, 2003). These studies also analyse whether there is an increase in local market competition due to presence of multinational corporations in the existing market structure of the host economy. They also study the demonstration effects and labour training in foreign multinational corporations. Smarzynska (2002) points out that these studies rarely offer quantitative information and generalisation is also very difficult.

The first hand studies, relating to industry, examine the effects of presence of foreign firms on the sectoral productivity of host countries. These studies estimate the production and function of local firms and include foreign share of the industry as one of the variables (Blomstrom & Kokko, 2003). The earliest studies done by Caves (1974) for Australia, Globerman (1979) for Canada, and Blomstrom & Person (1983) for Mexico, examine the impact of foreign multinational corporations on labour productivity of local firms. These studies have concluded that there are positive spillovers from foreign firms to the local firms.

The cross-sectional analysis of Blomstrom & Wolf (1994) for the Mexican manufacturing sector for the period 1965 to 1982, found significant spillovers to local firms. Though these studies find positive spillovers to the host country, the effect of these spillovers greatly varies between industries and countries. A significant problem faced by these studies is that they suffer from establishing the direction of causality i.e., whether high productivity is due to foreign firms or since the industry is potentially productive, it attracted the foreign firms (Saggi 2000; Smarzynska, 2002). The reason could be that the foreign firms were attracted to the most productive sectors of the economy.

The firm level studies examine whether productivity of domestic firms is correlated with the extent of foreign firm’s presence in their sector or region. The firm level studies, to some extent, control the self-selection problem i.e. foreign firms’ tendency to invest in high productivity sectors (Saggi, 2000). Haddad and Harrison (1993) did a comprehensive study for the manufacturing firms in Morocco for the period 1985 to 1989. The authors did not find any significant positive or negative spillovers, but they found the effect of FDI at the
sectoral level to be more positive in low technology sectors. They interpret this result as indicative of the lack of absorptive capacity on the part of local firms in the high technology sectors, where they may be behind foreign firms and unable to absorb the foreign technology (based on Saggy, 2000).

Vineesh Kathuria (1998), in his study, examined whether there is positive spillover from foreign firms and disembodied technology imports to the Indian manufacturing sector. He has used stochastic production methodology and looks into spillover effect on the multifactor productivity. The study uses the panel data for 368 medium and large sized Indian manufacturing firms for the period 1975-76 to 1988-89. The author found that the domestic firms tend to benefit from the presence of foreign owned firms, irrespective of the technological and production requirement of the sector. When the firms are divided into scientific and nonscientific industries, the firms belonging to the scientific group benefit most from foreign firms, once initial level of productivity gap is reduced.

The study also found no evidence on positive spillovers from disembodied technology imports to local firms in a sector. In another study on technology spillover and quality of technology transferred to the Indian industries, Ray (2000) has used panel data for the chemical and pharmaceutical industries from Capitaline Database. The technology quality has been measured in two ways:

- value of plant and machinery divided by gross block;
- normalised average distance of firm from the frontier production function. Spillover has been measured by the Herfindahl index.

Ray has shown that the patent regime has an impact on the quality of technology, but, in her study, the relationship between spillover and the quality of technology is not statistically significant in all cases.

Smarzynska (2002) examines the productivity increase in domestic firms by foreign firms for the Lithuania country for the period 1996 to 2000. The study uses panel data and estimates productivity through the parametric estimation method. The study finds existence of positive spillovers from FDI taking place through backward linkages but no evidence of spillovers through horizontal channels. The horizontal channels may be prevented through high wages for workers, which is not feasible by local firms to offer. The study found that “ten percent increase in the foreign presence in downstream sectors is associated with a 0.38 percent rise in output of each firm in the supplying industry”.

The study also found that the productivity effect is larger when the multinationals in the sourcing sector are oriented towards supplying the domestic product rather than focussing mainly on exporting. The study cautions that the positive spillover does not justify for subsidies since the foreign firms may cause exit of the less efficient domestic producers, thus lowering the demand for domestically produced intermediates, or they may import their inputs. In the above cases it may lead to a welfare loss in the economy.
Chapter 4

FDI and Incentives

In the previous section, the empirical literature on the kinds of performance requirements imposed by many developing countries, in order to channel FDI into 'desired' areas, was surveyed. It is obvious that these performance requirements would be ineffective if dictated by the efficiency requirements of the foreign firms. Since performance requirements are generally irksome to most TNCs, both developed and developing countries are often induced to give incentives to soften their impact (for a detailed discussion see Nunnemkamp, 2003).

Incentives are widely offered both by developed and developing countries to attract FDI into the country. The globalisation process of economies has increased the significance of competition, among governments to attract FDI, thereby leading to global bidding wars (Oman, 1999). The competition tends to be intense, particularly for high technology industries e.g. automobiles and for large infrastructural investment projects. There are mainly two types of FDI incentives offered by countries. They are:

- fiscal incentives, i.e. policies that are designed to reduce the tax burden of the firm, e.g. tax holidays, import duty exemptions, etc; and
- financial incentives, i.e. direct contributions to the firm from the government, e.g., direct capital subsidies, subsidised loans etc. The fiscal incentives are mostly offered by developing countries whereas industrialised countries offer financial incentives.

The increasing global bidding war has led to the fear that it may lead to a "race to the bottom". Overbidding is also aided by the fact that some of the benefits are easily observable, while the costs are distributed over long periods of time and hard to measure (Blomstrom & Kokko, 2003). The concern is over the competition for FDI leading to favouring of multinationals at the cost of the host country. The incentives lead to weakening of public finances of host country and a decrease in the welfare of its citizens, through distortion in the allocation of real investment.

The FDI incentives can be justified on the grounds that foreign firms do not account for the social benefits achieved through externalities, such as product and process technology, management skills, and labour skills, which may spill over to local firms, thereby increasing the efficiency of the domestic markets. However the spillover benefits, between foreign multinationals and their host economies, seem to vary between industries and countries (Blomstrom & Kokko, 1996).

The direct costs associated with incentives are very huge, particularly for the high technology-oriented industries. In 1996, the US State of

The FDI incentives can be justified on the grounds that foreign firms do not account for the social benefits achieved through externalities.
Alabama paid Mercedes Benz a subsidy of US$200,000 per employee, while Germany paid Dow Chemical US$3,400,000 per employee (Moran 1998). Fletcher (2002) calculated the revenue loss for Vietnam for the year 2001 from corporate income tax incentives and found it to be US$76mn, which is more than 0.7 percent of its gross domestic product. Apart from these direct costs, there are too many indirect costs associated with it, such as distortion in the allocation of resources etc. The studies also reveal that discriminatory selection of incentives, with lack of transparency, may increase the rent seeking activities, corruption, as well as impose huge administrative costs.

Therefore, the studies suggest that there should be no discrimination between the domestic investor and the foreign investor on availability of incentives. Some studies have concluded that the government should take efforts to scale back and streamline the existing tax incentives (Morrisset, 2003; Fletcher, 2002).

The kinds of incentives the countries in South Asia have offered to attract foreign direct investment were discussed in details. Have these incentive schemes worked? This question can be faced at two levels. At the more meaningful level, one has to make an estimate of the costs of incentives. Fiscal incentives cost the exchequer directly in terms of revenue loss. But there are indirect costs, if the incentives crowd out local investment, in the private or public sector. It is extremely difficult to estimate these costs because many of these are invisible and conceptual in nature. On the benefit side, there are many factors to look at, such as forward and backward linkages of FDI, job creation, increased exports, introduction of new management and production techniques, transfer and spillover of technology, etc.

The most serious problem in the assessment of benefits of FDI is in showing that these benefits are solely caused by FDI, and not by any other factors that have very little to do with FDI incentives. A less meaningful way to talk about the effectiveness of FDI incentives is to find out the extent of technology transfer, and spillover or export growth that has occurred in a South Asian country after it liberalised FDI policy. There have been some studies, taking the latter approach, but we have not found any study on the cost-benefit analysis of FDI incentives.

Country studies on this issue have revealed that incentives play a secondary role in attracting FDI, the primary determinants being economic fundamentals and political stability (Kokko, 2002; Blomstrom & Kokko, 2003; Oman, 1999). Nevertheless the significance of FDI incentives in attracting FDI has increased in the globalisation era, particularly due to the regional integration of the economies (Morrisset, 2003). The incentives seem to be effective in attracting FDI within regions, when the initial investment decision has been taken and the investor is choosing between alternative locations in a given region (Blomstrom & Kokko, 2003; Morrisset, 2003). The incentives are particularly effective for mobile firms & firms operating in multiple markets e.g., banks, insurance companies etc. and in investment decisions of export oriented industries (Morrisset, 2003; Bergsman, 1999).
There is no clear-cut conclusion on which type of incentives are effective and to what extent incentives, especially tax incentives, play a role in attracting FDI. Bergsman (1999) argues against the use of tax holidays, as it is usually not cost effective and has maximum effect only on short-term investments. He suggests that preferred incentives such as tax credit, faster depreciation etc. are better, since these can be applied to whatever expenses government wants to promote, such as fixed investment, labour investment etc. Fletcher (2002), in his study on Cambodia, Lao PDR and Vietnam, concludes that simple uniform regimes with low to moderate rates of corporate income tax may be preferable for promoting investment, rather than discriminatory tax incentives. He also suggests that if tax incentives are to be used, the accelerated depreciation is likely to be more efficient than tax holidays.

As the significance of incentives in attracting FDI increased, the countries have started to tax income from foreign capitals at rates lower than those for domestic capital and to subject different forms of foreign investment to very different tax treatment (Hanson 2001). There is some empirical evidence suggesting that tax rates do affect the FDI inflow into the host country (Devereux & Griffith, 1998; Hines, 1996). Hines (1996), in his study for the USA, found that “investors with no tax credit appear to reduce their investment shares, relative to foreign tax credit investors by 9-11 percent for every one percent increase in the rate of taxation”.
Chapter 5
Incentives in South Asia

By and large, the literature has concentrated on the impact of incentives in the context of developing countries in South East Asia, China and Latin America. As we have mentioned earlier, this is due to the historical dominance of these countries as host countries for FDI. Be that as it may, in this section we will look at studies that have looked at the issue of incentives in South Asia, and, in particular, in India, Pakistan, Bangladesh and Sri Lanka.

Bangladesh

In South Asia, Bangladesh is one country, which perhaps offered the best of incentives to attract FDI but ended up in a situation where the TNCs started pulling out of the country. For instance, two US companies, Occidental and AES pulled out, albeit Bangladesh was not quite satisfied with the performance of these companies. But the withdrawal of Shell operations in Bangladesh is being considered a disastrous blow to its FDI policy. According to the Board of Investment of Bangladesh, FDI inflow in Bangladesh has declined from US$394mn in 2001-2002 to US$175mn in 2002-2003. According to the World Investment Report of 2002, FDI inflows to India went up from US$2,319mn in 2000 to US$3,403mn in 2001, which is a 47 percent increase. Pakistan, too, has experienced an increase in FDI inflow, where it reached US$385mn in 2001, a 26 percent increase over US$305mn in 2000.

But FDI inflows into Bangladesh declined by 72 percent in 2001 and reached US$78mn against US$280mn in 2000. The draft summary report of the Second National Reference Group meeting (under the Investment for Development project of CUTS; NRG, 2002) has identified three basic reasons for the failure of incentives:

- lack of profit opportunities due to the high cost of doing business in Bangladesh;
- lack of consistency between policy and reality, as well as lack of transparency and good governance; and
- lack of local partners.

The last reason cited here is particularly relevant for FDI in the textile sector. The report also mentions that the level of infrastructure development in Bangladesh is not adequate to sustain a high rate of FDI inflow.

Many studies, such as Sorsa (2003), have shown that it is better to improve the overall business environment and maintain clear, predictable and transparent rules for all types of business, rather than give incentives selectively to some industries. Perk-filled economic zones are seen to have a mixed impact on FDI, but they
create a discriminatory policy environment, particularly against small investors who are likely to generate more employment than big TNCs.

According to Sorsa, (2003) benefits from special economic zones have been limited in Bangladesh, Sri Lanka, Jamaica, El Salvador and Phillipines in terms of jobs and linkages to the economy (the zones tend to create only highly specific semi-skilled jobs) and exemptions from indirect taxes (value added tax, excise, etc.) have been misused by transferring purchases to unqualified users. The SACEPS Task Force Report (2003) has made many of the points discussed above regarding the effectiveness of FDI incentives, and stressed on governance constraints and how these have hampered investment performance in India and Pakistan. Some of the salient features of this report are given below:

- In India and Pakistan governance related constraints have raised both fixed and variable transaction costs of doing business. Fiscal and judicial systems are directly raising investor's uncertainty. By rationing access to loan credit markets, investor risk has gone up, particularly for small and medium enterprises.
- South Asian economies are capable of achieving higher rates of growth by offering incentives for firm-level R&D and by investing considerably in education, health and social services.
- There is a considerable amount of inter-regional competition for FDI in South Asia and there is an urgent need to harmonise FDI incentives in the region. FDI incentives should be linked to activities that create the strongest potentials for spillovers and these activities are identified as education, training, export-related links and domestic joint ventures in technology intensive sectors.
- A reform of the banking sector is urgently needed so that state subsidy to cover for inflation risk for the private sector banks is stopped and risk-adjusted capital adequacy norms are introduced.

There have been some recent studies looking at the pattern of FDI flows into Bangladesh, as well as the incentives that are likely to work better than others. Azim (2000) looks at the pattern of foreign investment in Bangladesh up to December 1997, and finds Malaysia to be the largest source of FDI, followed by South Korea, Hong Kong, UK, Japan, Singapore, USA, Germany, India and China. The sectoral pattern demonstrates textiles and garments as the largest recipient of FDI as a composite sector, followed by drugs and chemicals, agro-based industries, paper and allied products and cement and ceramics sectors. The EPZs account for about 20 percent of the total stock of FDI in Bangladesh.

In another study Azim and Uddin (2001) have tried to identify the incentive package that is likely to attract foreign investment, as well as the negative factors that will deter foreign involvement in the economy, by collecting data from 15 foreign firms operating in Chittagong Export Processing Zone on 32 variables related to economic, social/physical and political government factors. The favourable economic factors are:

- tax and other incentives;
- preferential trade arrangement with neighbouring and developed countries; and
- availability of qualified managers and unskilled workers.
The unfavourable factors are:
- strike and demonstrations;
- corruption;
- law and order situation; and
- bureaucracy and red tape.

**India**

The studies on the effectiveness of FDI incentives in India have reached diverse conclusions. Balasubramaniyam and Mahambre (2003) assert that India is a potential recipient of large FDI flows due to its large domestic markets, but are doubtful that FDI would significantly raise employment and cause a substantial technology transfer. Feinbery and Majumdar (2001), in their study on the pharmaceutical industry for the period 1980-94, have found that technology spillover occurs between multinational firms but has little effect on domestic firms. The work by Mahambre (2001) primarily deals with the export performance of Indian manufacturing firms in chemicals, drugs and non-electrical machinery for the period 1988-89 to 1997-98. The general conclusion is that the technology spillover is high in industries where the technology gap between foreign and Indian firms is small and in markets where there is a strong competition between foreign and Indian firms.

In another study, Agrawal (2000) has worked on the effect of FDI on real investment using panel data on all South Asian countries, viz India, Sri Lanka, Pakistan, Nepal and Bangladesh, for the period 1965-1996 and has shown that “a one percent increase in FDI is associated with a 4-5 percent increase in nationally owned investment in the long run” through backward and forward linkages.”

Basant and Fikkert (1996) have used firm level panel data for 787 Indian firms in food processing, metals, chemicals and drugs, textiles, transportation, electronics, machinery, non-metallic minerals and rubber products for the period 1974-75 to 1981-82. Their main finding is that when all industries are considered, there are high rates of return on both technology purchase and R&D, though they could not distinguish between foreign and domestic technology purchases due to a multicollinearity problem. They also found significant differences among scientific and non-scientific firms, with the rates of return on technology purchase much higher for the former group of firms. In a panel estimate of stochastic production frontier for the period 1990-91 to 1999-2000 for the engineering firms in India, Goldar et al. (2003) have shown that firms with 20 percent or more foreign ownership have higher technical efficiency than domestically owned firms, and that the firms that are more international trade oriented are more technically efficient.

**Pakistan**

Like Bangladesh, Pakistan represents a country where FDI has been falling in the recent past (see Dawn, 2001). Pakistan started encouraging FDI particularly after 1991-92. Prior to this, there was a specific bias in favour of import-substituting FDI (see Graham and Krugman, 1993; Naujoks and Schmidt, 1995). Yet, as given in the World Investment Report (2001), FDI started declining in 1997 from...
about US$714mn to US$308mn in 2000. The jump in FDI in Pakistan in the 1990s was mainly due to an influx of external IPPs (Independent Power Producers). In 1994, utilities accounted for 31.7 percent of FDI. Within power producers, the dominant one was Hubco Corporation.

As noted in Khan et. al. ((1999), a wide range of fiscal and administrative incentives were given to lure FDI to Pakistan. Incentives to FDI ranged from 100 percent foreign ownership to relaxing the requirements of compulsory listing in stock exchanges. In addition, there are no limits on remittance of profits, dividends or royalties, and disinvestment of original investment is permitted at any time.

As clearly brought out in Khan (op. cit.) the IPPs in fact turned out to be a major liability. The net result was a massive overcapacity in power. At the same time, the IPPs imposed a recurring liability of US$0.9–1.4bn over the next 14 years. This is an enormous liability given that Pakistan's reserves are around US$1.3bn. The same issue is raised in Bari and Cheema (2001). In a comprehensive study for South Asia in general, they argue that competition for FDI among South Asian countries has led them to offer incentives which are often at the expense of the economies. Thus, in Pakistan, the constraint to FDI is poor governance and infrastructure leading to high transaction costs, rather than the lack of incentives (see also Khan, 1997) . The judicial system also prevents any implementation of FDI-friendly measures.

The general point seems to be that without the basic minimum requirements for absorbing FDI, incentives play no role in encouraging FDI (see also WIR, 2001, Ch. IV). Hence, as argued in Khan, what is necessary is a coordinated FDI policy for South Asia in general, not individual country incentives.

**Sri Lanka**

Sri Lanka is classic small country, which should maintain an open economy with respect to the rest of the world. Accordingly, in 1977, it shifted its industrial policy to end the anti-export bias. The principal instrument chosen was the formation of Export Promotion Zones (EPZs). Foreign firms in these EPZs were given a large number of incentives, including 100 percent foreign ownership, no tax on remittances for 10 years, no tax on remuneration of foreign personnel and payment of royalties and dividends, double taxation relief, foreign currency at world rates and duty free imports (see Ramanayake, 1984). In addition, there were cash grants to export oriented units and subsidised rates on utilities. In 1990, ownership restrictions were also removed on units located outside the EPZs.

Besides, this had little impact in terms of additional FDI, given the political instability after the mid-'80s (see Athukorala, 1995). In order to make the climate even more favourable for FDI, the ILO convention on not employing women in night shifts was relaxed. This, however, led to the employment of low paid women, which brought in the issue of whether FDI was being exploitative (see Lee, 1984; Abesinghe,1991). Other authors also argued that the overall
investment climate was far more important in attracting FDI than all the incentives given (see Athukorala, op cit).

Nepal

Given the small size of the economy and its land-locked nature, it is clear that incentives in Nepal would have to be linked to exports, or its development as a local organisational base for TNCs. One example of incentives offered by small countries is tax incentives.

A fairly comprehensive study for some developing countries, including Nepal, is found in Bergsman (1999). The study was a combination of analytical research and ground level surveys. A major conclusion is that most tax incentives are not effective. In fact the most important incentive for FDI is protection, which has little relevance for small countries like Nepal and other countries in a WTO world. The study also finds that fiscal incentives like accelerated depreciation, and duty free imports of machinery seem to have no impact on the capital intensity of production in practice. Still, these are costly for a small country in terms of income foregone. An important example is given of sub-Saharan Africa, which offers generous tax holidays, but gets no FDI.

A similar conclusion is reached in Guisinger (1985), and Bond and Samuelson (1986). Anyhow, this study argues that incentives are useless, because they tend to be matched by neighbouring countries. Therefore, the incentive race in a neighbourhood is a classic example of the isolation paradox. Only a coordinated regional policy can lead to an end to this ruinous game of competitive tax incentives.

In another study, Rolfe et al. (1993) argues that even at the micro firm level, incentives may or may not work, depending on the kinds of firms they are targeted at. On that account, new firms would prefer tax incentives that reduce the fixed start-up costs of new operations. On the other hand, established firms would prefer direct profit related tax incentives. The same issue is taken up in Bergsman (op. cit.) who argues that incentives in small countries seem to work only for footloose firms. In particular, they argue that the perceptions of the bureaucracy that incentives work, may be due to their excessive firm level focus and/or the need to generate the basis for bribes.

Since 1992, Nepal has been getting more and more proactive in encouraging FDI. Especially after passing the Foreign Investment and Technology Transfer Act, 1992. So far, little FDI has resulted (Kathmandu Post, 2002; World Investment Report, 2003). This issue is highlighted in a comprehensive study of South Asia (SAWTEE, 2003). The study finds that India has been the most successful in getting GFI. Despite Nepal’s proactive FDI policy, there was a 91 percent decline in FDI in 2002-03, mainly because of the increased complexity of India’s policy towards Nepal, and greater flexibility of India’s policy towards FDI. The study goes on to argue that excessive concentration on carrots for FDI in this region might lead to a collective loss for the countries of the region.

A detailed cost-benefit analysis of FDI in Nepal is found in Chitrakar and Weiss (1995), one of the very few studies on cost-benefit analysis.
of FDI in developing countries. They find that the main benefit to Nepal seems to come from tax revenues from foreign firms. For this reason, they caution against the use of tax holidays to encourage FDI. The emphasis on cost-benefit analysis is also found in Parris (2001). Surprisingly, few comprehensive studies are found for developing countries, especially in South Asia.
Chapter 6

Conclusion

This study has tried to review the literature on performance requirements and incentives, with special reference to South Asia. It is clear that existing studies have, by and large, concentrated on countries of Latin America and South East Asia among the developing countries. This is not surprising, given the importance of these areas for FDI, particularly in the second half of the last century. Over and above, South Asia is emerging as the newest focus area for FDI, particularly as most of these countries have been opening up to FDI, starting in the 1990s.

The survey of theoretical literature on performance requirements indicates that a case can be made for imposing such requirements, particularly from the welfare point of view. This is based on the common sense proposition that since FDI itself operates in an imperfect world, then government policy, which tries to counter this imperfection, could well improve welfare.

Be that as it may, the experience of the developing world including South Asia, indicates that in competing for FDI, countries tend to offer a whole host of incentives, fiscal and administrative. So far, few studies have tried to quantify the costs of these incentives. The principal problem seems to be that these incentives are often given to soften the impact of performance requirements. In the bargain, these incentives tend to be particularly costly over a period of time.

Given the evolution of these costs over time, these incentives tend to be politically invisible. Often, the purpose of these incentives may be to generate the supply of side payments of the bureaucracy. Even more important, there seems to be some consensus that FDI is a function of macroeconomic parameters, like, size of the home or export market, policy stability etc., rather than specific incentives. Incentives seem to affect mainly footloose FDI, or, at best, lead to relocation of FDI within a region. This latter advantage disappears when one sees that countries of a region tend to compete in incentives. This incentive competition can be particularly expensive for the region as a whole.

There are hardly any studies on cost-benefit analysis of incentives, even though only such studies, on the effectiveness offered by South Asian countries to attract FDI, can tell us which set of incentives should be offered. The studies on incentives in South Asia seem to identify the following benefits: increase in employment and/or wages, reduced prices or improved product quality, more revenues for the government and indirect benefits through professionalism, learning
and technology diffusion. The latter is also the principal motivation for developing countries. On the costs side, there are costs related to providing facilitation to foreign investors, which have an impact on national savings, deterioration in trade conditions and balance of payments.
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12. Negotiating the TRIPs Agreement: India’s Experience and Some Domestic Policy Issues

This report shows particularities about the subject that distinguished the TRIPs (Trade Related Aspects of Intellectual Property Rights) negotiations from other agreements that make up the Uruguay Round results. It also analyses the way in which the TRIPs Agreement was actually negotiated and handled.

The author finds that many of the lessons that can be drawn from India’s experience with the TRIPs negotiations are the same as those that can be drawn from the negotiations more generally and true for many other countries. It goes beyond a narrow analysis of events relating strictly to the negotiations during the Uruguay Round and looks at the negotiating context in which these negotiations took place.

The research findings draw lessons from what actually happened and suggest how policy processes can be reformed and reorganised to address the negotiating requirements in dealing with such issues in the future.

(Rs.100/US$25, ISBN 81-87222-50-6)


The latest report of CUTS on Multilateral Environmental Agreement, Trade and Development, examines the role of provisions for technology and financial transfer as well as capacity building as an alternative to trade measures for improving compliance and enforcement. It acquires specific significance in the light of the fact that the WTO members for the first time, in the trade body’s history, agreed to negotiate on environmental issues at the Fourth Ministerial Conference of the WTO at Doha.

This study also examines pros and cons of Carrots and Sticks approaches, and analyses incorporation of these approaches in three major MEAs, the Montreal Protocol, The Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES) and the Basel Convention, to find out which approach has been more successful in ensuring enforcement and compliance.

A must read for different stakeholders involved in this process, as this study would provide useful inputs towards trade and environment negotiations.

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14. Market Access Implications of SPS and TBT: Bangladesh Perspective

As both tariffs and other traditional trade barriers are being progressively lowered, there are growing concerns about the fact that new technical non-tariff barriers are taking their place, such as sanitary and phytosanitary measures (SPS) and technical regulations and standards.

The poor countries have been denied market access on quite a number of occasions when they failed to comply with a developed country’s SPS or TBT requirements or both. The seriousness of this denial of market access is often not realised unless their impact on exports, income and employment is quantified.

In this paper, the author focuses on the findings of a 1998 case study into the European Commission’s ban of fishery products from Bangladesh into the EU, imposed in July 1997.

This research report intends to increase awareness in the North about the ground-level situation in poor and developing countries. At the same time, it makes some useful suggestions on how the concerns of LDCs can be addressed best within the multilateral framework. The suggestions are equally applicable to the developing countries.

(Rs. 100/US$10, ISBN 81-87222-69-7)

15. Voluntary Self-regulation versus Mandatory Legislative Schemes for Implementing Labour Standards

Since the early 1990s, globally there has been a proliferation of corporate codes of conduct and an increased emphasis on corporate responsibility. The idea is that companies voluntarily adopt codes of conduct to fulfil their social obligations and although these companies are responsible only for a fraction of the total labour force, they set the standards that can potentially lead to an overall improvement in the working conditions of labour.

These voluntary approaches are seen as a way forward in a situation where state institutions are weakened with the rise to dominance of the policies of neo-liberalism, and failure of the state-based and international regulatory initiatives.

Given this background, this paper examines how the failure of 1980s codes, regulated by international bodies, resulted in the proliferation of corporate codes of conduct and an increased emphasis on corporate social responsibility.

This paper further tries to explore whether voluntary codes of conduct can ensure workers’ rights in a developing country like India.

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South Asian Countries have the highest rates of child labour practices in the world. As a result of the advocacy by powerful political lobbying groups supported by Europe and the US, the trade sanction approach to encounter the issue of child labour has gained influence, since the nineties.

These sanctions were exercised to alleviate the problem of child labour by US policy-makers and also by some countries in the EU. But, the question arises – have the trade sanctions imposed by these countries in any way helped eliminate this problem? This research report of CUTS Centre for International Trade, Economics & Environment tries to address this question.

It has explored the impact of these trade sanctions and finds that these sanctions resulted in the contradiction of the basic objective, i.e., elimination of child labour. By banning the import of those goods in the production process of which child labour was used wholly or partly, the developed countries have aggravated the sufferings of child labour and their families.

Besides highlighting the causes of child labour, the report makes some very useful recommendations on how the issue of child labour can be addressed best at the domestic as well as international level.

(Rs.100/US$25, ISBN 81-87222-82-4)

17. TRIPS and Public Health: Ways Forward for South Asia

Trade Related Aspects of Intellectual Property Rights — or TRIPS — has always been one of the most contentious issues in the WTO. Several studies have been conducted on the political economy of TRIPS vis-à-vis WTO, the outcome of which are crucial to the policymakers of the developing economies more than those in the rich countries. Increasing realisation of the poor countries’ suffering at the hands of the patent holders is yet another cause of worry in the developing and poor countries.

This research document tries to find an answer to one specific question: what genuine choices do policymakers in South Asian developing nations now have, more so after the linkage between the trade regime and pharmaceuticals? Starting with a brief overview of the key features of the corporate model of pharmaceuticals, the paper provides some insight into the challenges faced by the governments in South Asian countries. The aim is to anchor the present discussion of public health and the impact of TRIPS in the socio-cultural environment of this region.

(Rs.100/US$25, ISBN 81-87222-83-2)

18. Bridging the Differences: Analyses of Five Issues of the WTO Agenda

This book is a product of the project, EU-India Network on Trade and Development (EINTAD), launched about a year back at Brussels. CUTS and University of Sussex are the lead partners in this project, implemented with financial support from the European Commission (EC). The CUTS-Sussex University study has been jointly edited by Prof. L. Alan Winters of the University of Sussex and Pradeep S. Mehta, Secretary-General of CUTS, India.

The five issues discussed in the book are Investment, Competition Policy, Anti-dumping, Textiles & Clothing, and Movement of Natural Persons. Each of these papers has been co-authored by eminent researchers from Europe and India.

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This research report is a sincere attempt to fathom the relevance of SPS and TBT Agreements, their necessity in the present global economic scenario and, of course, the development of case law related to the Agreements, along with a brief description of the impact of this case law on developing countries.

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The purpose of the study is not to rehearse the never-ending story on the pros and cons of the trade-labour linkage. It not only seeks to assess the current and possible future direction of the debate from the developing countries’ perspective. It is hoped that this approach will provide developing countries with concrete policy suggestions in terms of the way forward.

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This study by CUTS Centre for International Trade, Economics & Environment attempts to highlight concerns about the industrialised countries exporting domestically prohibited goods (DPGs) and technologies to the developing countries that are not capable of disposing off these substances safely, and protecting their people from health and environmental hazards.

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