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Institutional Models of Foreign Direct Investment Attracting. Comparative Aspects

Abstract

The chapter examines the effectiveness of different institutional models of foreign direct investment (FDI) attracting and the relationship between institutional framework and the scale of FDI flows into countries being in process of catching up with developed economies. The experience of such countries as Ireland, Czech Republic, Hungary and Poland is used for studying this problem. The results indicate that the most effective institutional framework supporting the inflow of FDI to a host country is to set up a quasi-governmental agency promoting FDI. This agency should be of one–stop-shop character and endowed with appropriate authorisation. The adopted institutional framework must be harmonised with the basic assumptions of the policy towards foreign investors. The scale of FDI inflows into host countries depends only to limited degree on institutional solutions. The character of policy towards foreign investors and traditional location advantages seem to play more important role.

1. Introduction

The second half of the 1990s brings a rapid increase in flows of foreign direct investment (FDI) in the world economy. The reasons for growth in these flows are mergers and acquisitions taking place mainly between highly developed countries. These countries invariably remain the most attractive place for locating FDI. They account, depending on the period, for two-thirds to three-fourth of the flows of FDI on the world scale. As a result of this situation, some countries face a strong competition on the part of other countries for attracting

FDI to their economies. The expressions of this competition are the liberalization moves of many of the countries hosting FDI. They lead to the creation of more and more liberal conditions of operation for direct foreign investors.

In the conditions of globalization and liberalization of capital flows, the policies of the particular countries towards foreign investors become similar but they can be pursued in different institutional frameworks. Their common characteristic is concentration on facilitation in running business.

The goals of this chapter are:

(1) to analyze and evaluate the institutional framework applied by the host countries that are interested in attracting foreign capital to their economies;

(2) to examine relations between policy towards foreign investors, the institutional models of attracting FDI and the scale of FDI inflow to countries being in the process of catching up with highly developed countries.

2. Characteristics of policy towards foreign investors in different groups of countries

Policy towards foreign investors conducted by a host country may have an interventionist or a liberal character. Generally, the higher the level of economic development of the country hosting investments, the smaller the extent of intervention on the part of the state. This paper analyzes institutional solutions used by countries catching up with the highly developed countries. A characteristic feature of the policies of this group of countries is to ensure a steady inflow of foreign direct investment and encourage foreign investors to get involved in these areas of the economy which strengthen its competitiveness. The basic strategies are as follows: either the offering of foreign investment incentives (benefits, exemptions, special regulations) or implementing a policy of strengthening economic "fundamentals" (infrastructure, education, economic stability, etc.), or both, with the aim of improving the attractiveness of their economies as a location for FDI (Ch.Oman, 2000). The justification of a policy constructed in this way is the conviction of the countries hosting FDI that an inflow of FDI can yield significant economic benefits and an appropriate policy can augment these benefits.

Countries hosting FDI, the less developed ones in particular, have to take into account factors which affect the efficacy of their policy towards foreign investors (World Investment Report 1999, p. xxvii). In this context, the commonly expected positive effects following from the inflow of FDI such as increases in financial resources and investments, augmentation of the technological potential, growth in the competitiveness of exports, creation of new and qualitatively better workplaces, demonopolization and promotion of competitive behavior, protection of the natural environment may not be revealed on the desired scale.

The particular countries' policies towards foreign investors become similar to each other and they concentrate on facilitation in running business. The main components of policy towards foreign investors are:

(1) investment promotion (promotion of a given country as a place for locating FDI; promotion of selected regions of the country or sectors of the economy);

(2) incentives - fiscal, financial and other stimuli and on the other hand, requirements made by the host country;

(3) servicing the investors after effecting the investments;

(4) improvement in the conditions of running business, reduction of the co-called "hassle costs" related to running business.

In the age of globalization manifested among others in liberalization of capital flows, countries hosting FDI have fewer and fewer tools at their disposal with which they can influence the conduct of foreign and domestic firms. The constraints on constructing this policy result from belonging to the WTO. They are related primarily to the Agreement on Subsidies and Countervailing Duties and the Agreement on Trade-Related Investment Measures. OECD member countries are additionally obliged to observe the Capital Movements Code. And the countries of Central and Eastern Europe applying for accession to the EU have to allow for the requirements following from the functioning of the single internal market.

The most serious constraints on a free shaping of policy towards foreign investors seem to be the provisions of the TRIMs/WTO on the one hand and on the other hand - the limited efficacy of incentives for foreign investors and limited financial resources of host countries. The provisions of the above Agreement prohibit applying towards foreign investors any measures that distort or disorganize international trade. From the viewpoint of the economic interests of less developed countries, the application of some of requirements related to foreign investors could be still justified. On the other hand, the application of incentives although widespread (UNCTAD 1996) can also lead to the occurrence of distorting effects in trade, similarly to the application of traditional trade barriers. The use of incentives of this kind is disciplined (restricted) by means of the provisions of the Agreement of Subsidies and Countervailing

Duties/WTO. Furthermore, the application of incentives involving public finances does not always yield the expected results under conditions of competition for an inflow of investment. There emerges a real threat that countries will outbid each other in offering the incentives. Countries incur costs (expenditure from the budget or loss of revenue to the budget) but in effect they may fail to attain a sustainable involvement of foreign capital in their economies.

3. Institutional framework of policy towards foreign investors

Policy towards foreign investors as a part of the particular countries' general economic policy is always conducted within a certain institutional framework. Countries interested in attracting foreign investors set up foreign investment agencies which may have a governmental, quasi-governmental or private character (UNCTAD 1997, p. 42). The establishment of an investment promotion agency can be treated as a response to market failure.

Activities that are possibly performed by a foreign investment agency (FIA) may be classified according to their importance (Co-operation at the European Level, 1997):

1. promotion activities, i.e. activities directly aimed at promoting foreign investment within a given country and encouraging any investors to invest;
2. servicing foreign investors; i.e. providing certain services to prospective and existing foreign investors;
3. protection activities; some activities performed by a FIA may be aimed at protecting a country against "bad" foreign investment or promoting only "good" investment rather than promoting any kind of foreign investment; these activities are typical for countries having not yet fully encountered economic liberalisation and embrace: screening of FDI, monitoring of FDI;
4. other possible activities; i.e. activities that are somehow linked with promotion of foreign direct investment; there are for example regional development and aid issues, servicing local investors, arbitration and alternative dispute resolutions, research activities.

The best practices in investment promotion recommended by UNCTAD (UNCTAD 1997) include:

– building a positive image of the host country, (on the basis of a rule that the spread information on economic, legal and social determinant in a given country conform with reality);

- being proactive in attracting investment projects; implementation of the targeted promotion approach is recommended here;
- facilitating the entry of new investment and the operations of established investors;
- promotion of outward investment.

The above mentioned types of foreign investment agencies distinguished according to their connections with the government are differently laid out in the particular countries. The character of ownership of the agency determines its configuration in the structure of governmental and non-governmental organizations and indirectly determines the scope of functions played by them.

The role of a governmental agency can be played by a department of one of the significant ministries (e.g. ministry of industry and trade or of the economy). It can also be a separate agency or an agency subordinated to the prime minister or president. The functions which it plays are as a rule limited and are confined to screening, monitoring and negotiations with investors. As regards the functions of investment promotion and investor servicing, organizational structures of this kind do not acquit themselves well (UNCTAD 1997, p. 42). This results from the character of governmental institutions, lack of preparation of civil servants for fulfilling the functions required in the sphere of business.

A quasi-governmental or quasi-private agency is as a rule a joint stock company funded by the government and reporting to it. In accordance with the binding legal requirements it has its own management and supervisory board but is subordinated to a given ministry. The agency has a right to recruit staff members who are not civil servants and to motivate them adequately. It can be expected that their skills will match the business functions played by the agency better than in the case of a typically governmental agency. The agency has the formal features of a private organization and is also a public utility institution. It is in close touch with public authorities. It has the best possibilities of fulfilling all the functions typical of an investment promotion agency. In practice two solutions are used. They the "strong" agencies endowed with appropriate powers and financial resources and performing all the functions mentioned earlier on. Agencies of this type are called "one-stop-shop". Another organizational solution is an agency which has a limited statutory functions and has no appropriate resources at its disposal.

Private agencies for investment promotion are a theoretically possible institutional solution. They can be private units with which the government subcontracts certain tasks or trade associations or interest groups oriented at playing functions typical of an investment promotion agency. The character of ownership causes this kind of agencies to understand the needs of investors well and to be able to perform certain functions better than the remaining types of agencies e.g. the servicing of investors. Their performance however may be hindered in the case of other functions owing to the non-profit character of certain activities such as e.g. the creation of a positive image of the country or owing to the separation from the government e.g. investment facilitation functions.

4. Status of investment promotion agencies in countries catching up with developed economies

The analysis is concerned with four countries: Ireland, the Czech Republic, Hungary and Poland that are in the process of catching up with highly developed countries. These countries apply an outward-oriented strategy with the use of foreign capital in the form of foreign direct investment. The institutional models of attracting foreign investment applied in these countries are different. In the case of Ireland, a model of an autonomous "strong" agency of the one-stop-shop type was implemented. In Poland and the Czech Republic they are quasi-governmental agencies but they are "weak" owing to the extent of their functions and resources at their disposal. Hungary adopted a different model, for one governmental agency deals with all the activities of promotion of investment and trade.

Industrial Development Agency Ireland (IDA Ireland) is sponsored by the state and supported by the EU programs. The Agency reports the results of its activity to the Ministry of Enterprises, Trade and Employment and in the case of the Centre of International Financial Services in Dublin to the Finance Ministry. The Agency acts under the acts on industrial development. Its main objective, according to the official declarations, is participation in the economic development of Ireland by encouraging international firms in manufacturing and services being the subject of international exchange to invest in Ireland and by encouraging firms already acting in Ireland to expansion.

The IDA belongs to the so-called strong agencies. It has at its disposal and administers incentives for investors - it gives grants. It has a right to take decisions in this field on he basis of a set of criteria. The IDA uses a selective approach to grants offered to foreign investors suitably to Ireland's economic policy. The measures of efficacy of its activities are the number of newly set workplaces in firms supported by the IDA and the net increment in workplaces, the cost of a sustainable workplace measured with an average sum of funds expended by the IDA per workplace and the regional structure of the newly created jobs.

In the case of the Czech Republic, its Agency for Foreign Investment, CzechInvest, is a governmental agency acting on a budgetary basis. It was established in 1992 in order to promote foreign investment in the Czech Republic and to assist foreign investors in carrying out investment projects. It is subordinated to the Ministry of Industry and Trade. In the 1990s, the Agency's activity consisted mainly in offering foreign investors information on possibilities of running economic activity in the Czech Republic and on the particular industries and in providing certain business services, e.g. seeking out appropriate production sites and premises or partners for setting up a joint venture, assistance in organizing meetings with local partners and in talks with representatives of state administration at the national and local levels. CzechInvest also rendered assistance in obtaining reliefs following from the governmental system of investment stimulation. The Czech Republic introduced a package of incentives for investors in April 1998. As we can suppose it was a reaction to a drop in the inflow of FDI to the Czech Republic in two consecutive years, i.e. 1996-1997. The Act on investment preferences was modified in 2000 (Act 2000). Similarities to the strategy towards foreign investors pursued in Ireland are visible here.

The institutional changes go in the direction of transforming CzechInvest from a marketing one into a development agency. The extent of functions fulfilled by it increased and is evolving towards the model applied in Ireland. The Agency is advertised as a one-stop-shop for incentive applications. Still it is not a "strong" agency in the sense described earlier on in the text.

Poland created also its State Agency for Foreign Investment (PAIZ), similar in character and configuration to CzechInvest. The PAIZ was a treasury-owned company reporting the results of its activities to the Ministry of the Economy. Its long-range goal was defined as participation in the economic development of Poland by promoting Poland as a location for foreign investment and provision of comprehensive services to foreign investors (Statues of the PAIZ). However, it was not a "strong" agency. It did not fulfill all the functions typical of such an agency. A package of incentives for investors which is offered on a national treatment rule was introduced in Poland. At the beginning of XXIst century Poland reorganized this Agency. Its name is The Polish Information and Foreign Investment Agency (PAIiIZ). Its mission is to attract foreign investment to the Polish economy and create a positive image of Poland in the world (www.paiiz.gov.pl).

Hungary, as it was already mentioned, adopted a solution different from the above. Its agency, Investment and Trade Development Hungary (ITD Hungary) established in 1993 is a governmental agency in which the whole of national investment and trade promotion activities are concentrated. The Agency is subordinated to the Ministry of the Economy and the Ministry of Foreign Affairs. The activity of the ITD covers the following areas (ITD Hungary 2001): promotion of foreign investment in Hungary, promotion of exports and trade consultations, assistance in entering into business contacts between Hungarian and foreign firms; business services.

From the characteristics of agencies for foreign investment in the selected countries it follows that Ireland adopted solutions which allow the IDA to acquit itself effectively of its basic functions which are ascribed to a typical foreign investment agency, i.e. promotion of the host country (selected sectors/regions), generation of investment and servicing the investors. The quantitatively specified goals and the awarded financial support impose also a necessity of screening and monitoring the inflowing foreign investment and allow the work of the agency to be evaluated in a broader context which is development of the Irish economy.

The Czech Agency fulfils promotional and information functions and conducts a partial servicing of investors and after the recent changes evolves towards the Irish model. However, there is no clear-cut criterion for evaluating the efficacy of its activities, for the goal whose execution might be measured has not been specified. A similar situation occurs in the case of the PAIZ. Hungary adopted an entirely different solution. The promotion of investment and trade (more specifically - export by Hungarian firms) was joined with investor servicing and business mediation in a single agency (ITD Hungary) to which the trade councilor's offices were simultaneously subordinated. This yielded an extended organization, different from a typical foreign investment agency. The surveyed countries compete with each other for inflows of FDI. The solutions used by Ireland and deemed to be very efficacious became a stimulus to changes in policy towards investors and to institutional changes in the sphere of promotion and investor servicing in the countries of Central and Eastern Europe.

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