How to Promote FDI?
The Regulatory and Institutional Environment for Attracting FDI

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I. An Enabling Environment for FDI

1. There is ample evidence that FDI is a key ingredient to sustainable economic growth.[1] Going far beyond simple financing, FDI is instrumental in the rapid and efficient cross-border transfer and adoption of best practice – ranging from technological, managerial, to environmental and social standards - which is the essence of economic development. Even during economic crisis, which tend to happen more frequently in a fast globalizing world economy, FDI has proven to be more stable than other forms of investment and helps host countries ride out crisis and return to growth.

2. However, FDI does not come without pre-conditions, nor can host countries reap all the benefits of FDI automatically. Just like any other business people, foreign investors are driven by profits. They go to places where the net profitability is highest, not inevitably where costs are lowest; and they transmit best practice when it is advantageous for them to do so, not necessarily when host countries need it. Hence, national governments have an important task to create the pre-conditions for beneficial FDI to enter and play its catalyst role in the host countries' economic development. This is particularly pertinent now, when the prospect of maintaining high levels of international investment is less certain than just a few years ago.

3. An enabling environment for FDI has several components. First of all, political and macroeconomic stabilities are an absolute pre-requisite for any kind of private investment, including FDI. Numerous studies have amply demonstrated that political and economic stabilities, along with the prospect of growth, are the most important determinants for FDI. Only in extreme cases, such as the existence of crucial natural resources, would a foreign investor go to a war zone or where there is rampant inflation.

4. Secondly, a sound policy and regulatory framework and efficient supporting institutions to enforce the relevant laws and regulations are imperative for FDI to enter and thrive. Especially in a globalized competitive market, the difference between countries in how conducive their investment climate may be, including how an investor is received, how many administrative and regulatory obstacles an investor has to overcome to enter and operate, and how commercial disputes are handled through the judiciary system have a huge impact on where the investor will go and how much contribution the investment will make to the host economy.

5. Finally, an adequate physical and social infrastructure complements a good policy and regulatory framework to create the necessary environment for attracting FDI. These include the quantity and quality of roads and communication systems, skilled labor, as well as the efficiency with which public services are delivered. They are also important if the full potential benefits of FDI presence are to be realized.

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[1] Sun, X. (2002), "Foreign direct investment and economic development: What do states need to do?", mimeo, The World Bank, summarizes the main benefits and the potential negative impacts of FDI on host economies.

6. Therefore, a sound policy, regulatory and institutional environment for FDI is one part of the larger investment climate that affects all private investors, both foreign and domestic. To encourage investment, the policies and practices should aim to reduce investor costs and the perceived risks associated with the investment, as well as creating an investment climate conducive for the domestic economy to benefit from such investments. Over the last decade or two, more and more developing countries have liberalized their economic policies. Lower tariffs, fewer quantitative restrictions, and currency convertibility have helped to encourage trade flows, and the importance of FDI in GDP has risen almost everywhere, thanks to fewer sectoral restrictions to foreign investors or the percentage of foreign ownership allowed, and a more favorable outlook towards FDI in general.

7. However, it should be recognized that the past few years have seen a resurgence of protectionism in many parts of the world due to economic downturn and instabilities. Although this paper focuses on the role of the governments in establishing a good regulatory and institutional framework to promote FDI, the underlying policies are even more important as they determine a country's most fundamental attitude towards foreign investment.

II. The Role of Regulation in Business Environment

8. In a world which has largely given up the debates between socialism and capitalism, the major discussion over the proper role of the governments in economic activities centers on its regulatory role. That is, despite the efficiency of the market, unregulated markets may lead to frequent failures, ranging from monopoly power to negative externalities. Therefore, a government that pursues social efficiency needs to counter these failures and protects the public through regulations.[2] The most common argument for enforcing government regulation is a natural monopoly situation where economic efficiency often requires a single operating firm. The prime examples of natural monopoly are utilities. To attract capital to this sector while avoiding excessive exercise of monopolistic power, public intervention is called for and regulations have been implemented in most countries to constrain the rate of return – most often in the form of price control – on capital. In this regard, the broad professional and public consensus is that without regulatory intervention, utility rates would be substantially higher than they are. In a similar vein, regulations are also considered warranted to ensure national security, public health, personal and environmental safety, as well as product quality.

9. However, since effective regulation of a natural monopoly is inconsistent with the interests of the monopolistic supplier, the interaction of the power of economics and the power of politics determines that the regulatory outcome may be one in which the regulator is captured by the regulated. That is, the benefits from regulation is reaped by

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[2] Pigou's public interest theory of regulation is found in his 1938 book, *The Economics of Welfare*, 4th ed., London: Macmillan and Co.

the monopolistic firm instead of the general public.[3] This may happen even where competition would otherwise prevail. A prime example of this is the transportation industry, where regulations typically lower output, raise price, and generate monopoly rents that did not exist before. Therefore, for government regulations to serve their ultimate purposes, they have to be designed and implemented in an objective, consistent, transparent, and non-arbitrary manner so that they are not used as a rent-seeking mechanism for industry incumbents, politicians, or bureaucrats.

10. Consequently, what is at issue is not to regulate private businesses or not, but whether such regulations are designed in incentive compatible ways, avoid adverse selection and moral hazard, are implemented expeditiously without harassment and corruption, and serve public interests. In this regard, two types of regulatory policies may be implicated to prevent and/or correct an undesirable outcome. Ex ante policies, such as safety standards and user permits, regulate an activity to prevent negative results from occurring, while ex post policies, such as exposure to tort liabilities, regulate an activity only after harm has been done. In the latter case, the threat of penalty causes the potential offender to internalize the expected social damages and to take necessary precaution. The choice between these two policy tools depends on the administrative costs of the regulatory policy.[4]

III. The Regulatory Framework for FDI

11. A country's regulatory framework is a tool to support its policy choices towards FDI. Consisting of a set of commercial laws and regulations, as well as the institutions established for their enforcement, it provide the overall framework to govern its market transactions and a process to settle disputes. This framework provides a degree of confidence required by foreign investors to enter into business transactions in this country. It seeks to assure private investors that a particular business transaction is permitted, and that once entered into, the transaction will be protected and the supporting agreements enforced. Especially in situations where a government is introducing a major departure from the previous treatment of foreign investors, such a framework serves to promote the government's objectives and policies for attracting, facilitating, and safeguarding foreign investment.

12. Therefore, as a decisive element in creating an overall enabling business environment supportive of private sector endeavors, the key elements of an effective regulatory framework for FDI include a body of clear laws and regulations and the efficient administrative bodies.

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[3] For more details on public choice theory of regulation, see Tullock, G., "The welfare cost of trariffs, monopoly, and theft," *Western Economic Journal*, V., 1967; Stigler, G. J., "The theory of economic regulation," *Bell Journal of Economics and Management Science*, II, 1971; and Peltzman, S. "Toward a more general theory of regulation," *Journal of Law and Economics*, XIX, 1976.

[4] Kolstad, C. D., T. S. Ulen, and G.V. Johnson, 1990, "Ex post liability for harm vs. ex ante safety regulation: substitutes or complements?, *The American Economic Review*, Vol. 80, No. 4.

13. When applied to FDI, the relevant regulations relate to the procedures that are put in place to screen for or control certain activities and investors who are planning to establish business in a given territory. As most of these are introduced ex ante, they are intended to prevent market failures such as low-quality products and services by fly-by-night operators and externalities such as pollution. By being registered, for example, "the new companies acquire a type of official approval, which makes them reputable enough to engage in transactions with the general public and other businesses."[5] Consequently, most investors, although they may grumble about administrative and regulatory procedures, understand that they are necessary and ultimately beneficial for the overall business environment.

14. Problems arise, however, when these regulations are designed and implemented in a manner that is inefficient, antagonistic, and arbitrary, which rather than protecting the general public, upholding the rights and obligations of the investors, and assisting the smooth functioning of the market, serve to protect industry incumbents by increasing the costs of entry, thus reducing competition and causing damage to consumers. In addition, poorly conceived and enforced regulations are easily hijacked by politicians and bureaucrats for rent creation and extraction, which not only incur additional costs on the investors, but also lead to corruption and other inferior social outcomes.

15. In respite of the growing consensus among policy makers that appropriate regulatory policy regimes are important factors in the proper functioning of the markets, there is less convergence on what constitutes an effective regulatory framework. Although the issue has generated considerable interests among policy analysts in recent years, there remains an empirical lacuna to link the suitable regulatory policy framework to a country's socioeconomic reality. In the absence of such theoretical guidance, solutions are sought for in best practice examples of what have worked on the ground. The following discussion starts with a review of the regulatory regimes in a cross section of countries, and concludes with an analysis of a best practice example through comparison with two less effective practices.

A. Realities of FDI Regulations Around the World

16. A pro-FDI regulatory framework begins with the adherence to "non-discrimination" principle vis-à-vis foreign investors. Discrimination may operate either by favoring the interests of host nationals over those of foreigners or by favoring the interests of foreigners of certain nations over foreigners of other nations. Since the scope of actions that may constitute "discrimination" is very broad, even international best practices fall far short of true "non-discrimination" in terms of equal treatment of all foreign investors. However, for any nation seeking to encourage economic development through foreign trade and investment, it is desirable to acknowledge the principle that the laws of the host nation should not discriminate against or between foreign investors

[5] SRI International, 1999, *International practices and experiences in business startup procedures*.

17. A related issue concerns the sectoral restrictions facing FDI entry. While a country may have legitimate reasons to restrict or ban FDI in certain activities – a foreign investor may be off limit to some sensitive sectors, be restricted to holding minority positions, or can only invest under special conditions - such restrictions and/or limitations will obviously have an impact on the overall inflow of FDI to the country, particularly where such restricted or limited sectors provide opportunities for the host country to attract FDI. Over the last decade, the general trend worldwide in the majority of developing countries has been to allow foreign investment in all or most sectors, while defining closed or restricted areas on a short "negative" list.

18. Under these principles, most countries' investment regulations concretize into a series of procedures that screen, approve, and monitor private investment, including FDI. While the list of procedures varies from country to country, they usually fall into the following three broad categories. Most of these procedures apply equally to both foreign and domestic investors, although some are clearly intended for foreign companies only.

- Entry procedures
    - Incorporation
    - Company registration
    - Sectoral licenses
    - Tax registration
    - Statistical registration
    - Social security
    - Incentive approvals
    - Visas, work and residence permits for foreign investors
    - Foreign exchange registration for foreign investment

- Locating procedures
    - Purchase/lease agreements
    - Land titling and cadastre
    - Land use permission/re-zoning
    - Environmental clearance/impact assessments
    - Construction permit
    - Site inspections
    - Occupation permits
    - Utility connections

- Operating procedures
    - Tax reporting and inspections
    - Fire, health and safety inspections
    - Import-Export procedures and clearances
    - Technical standard approvals/certification
    - Labor regulations

19. In theory, all these regulatory procedures may be necessary, with each serving a unique purpose. In practice, however, great variations exist between countries regarding which procedures are truly needed and how they should be administered. Inappropriate

regulatory systems can substantially reduce a firm's ability to compete internationally, distort investment decisions, or deter investment entirely. It is in such details that an investor discern a pro-investment regulatory framework from a deterrent one.

20. Looking at just the procedures required to start up a firm, that is, the entry procedures, a recent study on 85 countries found that the number of administrative and regulatory steps to gain legal status to operate varies from the low of 2 (Australia and Canada) to the high of 21 (the Dominican Republic), corresponding to a cumulative delay ranging from the low of 2 business days (Australia and Canada) to the high of 152 (Madagascar). Taking into account the aggregate time and out-of-pocket expenses in addition to official fees, the world average cost measure was fully two thirds of the average country's per capita GDP.[6] As in more than three quarters of the countries an average entrepreneur is expected to go through more than 7 separate steps to complete the startup procedures, wait for more than one month to obtain all the required papers, and pay more than 25 percent of the per capita GDP, legal entry alone already proves to be extremely cumbersome, time-consuming, and expensive in most countries in the world.

21. Moreover, as they are currently enforced, the stricter entry regulations are not necessarily related to better socioeconomic outcomes. To the contrary, in a cross section of countries, the above study found that more stringent entry regulations were closely associated with lower product quality, poorer environmental standard, inferior public health indicators, and lesser market competition. Therefore, in a majority of countries, although the various investment regulations are well-intended, they fail to achieve their original objectives. This is particularly the case with developing countries.

22. Taking into account a fuller range of relevant administrative procedures by including land access and site development, a recent FIAS study compiled a database on the administrative procedures in 32 developing countries worldwide to analyze comparative costs and delays associated with approval and permitting procedures in general business registration, site development and operational requirements.[7] The results indicate that, on average, investors need to comply with 53 different procedures, resulting in delays with respect to business establishment and operation of 443 days, which translates into imputed financial costs of close to US$6,000. Furthermore, it was shown that higher administrative and regulatory costs were significantly correlated with lower FDI flows for the countries examined, suggesting that the regulatory framework in these countries does not facilitate foreign investor entrance.

23. In addition to the direct (e.g. formal and informal payments, facilitation costs, expenditures on external advisors) and indirect (e.g. the inefficient allocation of firm resources in response to the distorted incentives created by regulations) costs imposed by a country's regulatory environment, a key dimension of regulatory compliance costs is the staff time lost in dealing with regulatory requirements and interacting with government officials. The World Business Environment Surveys, which covers over

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[6] Djankov, La Porta, Silanes, Schleifer, "The Regulation of Entry", Quarterly Journal of Economics, Feb. 2002.

[7] J. Morisset and O. L. Neso, "Administrative Costs to Foreign Investment in Developing Countries", World Bank's Policy working paper, n.1287, May 2002.

10,000 firms in over 80 countries and territories, reveal that on average around 15 percent of senior managers' time in South Asia and developing East Asia is spent on working with public officials on the application and interpretation of laws and regulations.[8]

24. Comparing the various types of investment regulations, the above series of surveys showed that there is a great divergence between countries in what constitutes the most constraint to enterprises. Nevertheless, tax regulations, including tax rates and tax administration, as well as customs regulations most often top the list of potential regulatory obstacles in terms of their negative impacts on the enterprises. In fact, in most countries, the policy and regulatory problems with tax and customs administration have not escaped the attention of the public officials. This is one reason why most special investment incentive schemes to attract FDI consist of simplified tax and customs treatments.

25. At the country level, a new World Bank study found that administrative procedures, and the costs and delays associated with them, can significantly influence the location of multinational firms and productivity in India.[9] Other studies, often via surveys, tend to confirm such conclusions. Therefore, rather than being a means to address market failures and to promote investment, the existing regulatory framework in a large number of developing countries is being perceived by many as an administrative obstacle. These administrative barriers can be particularly negative for foreign investors who are not politically connected, who operate under strict internal corporate guidelines, or who do not have local partners to take care of a multitude of procedural obstacles and associated payments. Accordingly, countries may lose the "good" foreign investors they precisely attempt to attract.

B. Best Practices in Investment Regulations

26. In this section, the regulatory practices of three countries (Canada, the Dominican Republic and Morocco) in company registration are compared in order to draw useful lessons in what an effective regulatory framework should aim to achieve. The examples are presented for illustration purposes only and by no means suggest that the "best practice" is the only way to go, or that countries with "less good practices" should copy the best practice without adapting to their individual needs. Indeed, a sound regulatory framework has to be set within a nation's own political, economic, social, and cultural context. Instead, the best practice is contrasted with other country examples to demonstrate the spirit and directions of what the governments should strive for when reforming their investment regulatory regimes if promoting investment is a policy objective.

27. Also, although company registration is selected for the in-depth analysis here, it does not mean that all will be well once entry procedures are streamlined. Quite the contrary, locating procedures are often even more complex in many countries because

[8] G. Batra, D. Kaufmann, and A. H. W. Stone, *Voices of the Firms 2000*, mimeo.
[9] World Bank, *Improving the investment climate in India*, February 2002.

they relate to other policy issues such as acquisition of land by foreign entities, which have to be resolved before the relevant investment regulations are designed. Similarly, operating procedures have more long-lasting impact on an investor than entry procedures because many of them are recurrent and have to be dealt with on a daily basis, and after substantial sunk costs have been incurred, which reduces the firms' range of choices.

28. The company registration procedures in Canada, Morocco, and the Dominican Republic are summarized in Table 1. More details can be found in Annex. As a best practice example, Canada has a very streamlined and self-monitoring procedure for company registration that include only two steps. The first step for anyone whishing to incorporate under the federal law in Canada is to verify the uniqueness of the proposed corporate name in its area of business. In order to do so, the company orders a Canada-biased NUANS report from a private firm known as a search house (trade mark agent) and submit the relevant company incorporation materials to the Canada Business Corporation Act (CBCA). Once the name is approved under the rules stated by the CBCA, the company can be registered. All the forms can be obtained electronically and payment can be made by credit card. After submitting all required documents, a certificate of incorporation can be downloaded within hours and the company may begin operation.

29. For tax registration**,** the company needs to fill out a different application form and submit it to the Canada Customs and Revenue Agency (CCRA). Like company registration, application forms can be obtained from the internet and submitted electronically, by fax or regular mail. Registration is done immediately and within a week the applicant receives a written confirmation of its business number (BN) along with its registration confirmation from CCRA. The entire company registration process is thereby complete. The total costs, including the time spent on filling out and submitting the forms, represent just 2.3 percent of the per capita GDP in Canada.

30. By contrast, the company registration process is considerably more complex in both Morocco and the Dominican Republic. It involves 13 and 21 separate steps, respectively, as compared to only two in Canada. To complete all the legal procedures, the applicant needs at least three months in Morocco, assuming no time is lost between procedures, and bears the cost equivalent to 44 percent of the country's per capita GDP. In the Dominican Republic, obtaining the right of entry requires four months of persistent paper and leg work, and carries the price tag of five times its per capita GDP.

31. Although it is difficult to argue that all the extra procedures in Morocco and the Dominican Republic are redundant, there certainly appears to be room for simplification and rationalization. First of all, in both countries, the applicant is required to register at multiple agencies, sometimes in parallel but most often in sequence. To fulfill the exigency of each agency, the same documents have to be filed each time. If the true purpose of getting clearance from each public agency is to ensure that the appropriate laws and regulations are observed, better coordination and wider information sharing among the various agencies would achieve the same objective, while reducing the investors' administrative burden substantially.

Table 1: Comparison of Company Registration Procedures in Three Countries

	Procedure	Duration (days)	Starting on Day	Ending on Day	Costs (US$)
	Canada				
1	Incorporate the company	1	1	1	$231
2	Register for a business number	1	2	2	$49
	Totals	***2***	***1***	***2***	***$280***
	Morocco				
1	Obtain certificat negatif	1	1	1	$15
2	Register bylaws at Ministry of Finance	1	2	2	$138
3	Deposit paid-in capital in the bank	1	3	3	$0
4	Deposit bylaws at Registrar	1	4	4	$20
5	Obtain patente number from Ministry of Finance	1	5	5	$0
6	Publish company information in Gazette official	30	6	35	$41
7	Publish company information in national paper	14	36	49	$41
8	Register at Tribunal of Commerce	1	37	37	$0
9	Get approval from Bureau de Placement	1	38	38	$0
10	File with Securite Sociale	1	39	39	$0
11	File declaration of existence at Ministry of Finance	2	40	41	$0
12	Prepare declaration to labor inspector	1	42	42	$0
13	Obtain local authorization to begin activity	15	43	57	$0
	Totals	***70***	***1***	***57***	***$255***
	Dominican Republic				
1	Deposit paid-in capital in the bank	1	1	1	$0
2	Notarize sworn declaration of payment	1	2	2	$231
3	Hire a certified public accountant	1	3	3	$312
4	Register company name	15	4	18	$3
5	Obtain receipt from Chamber of Commerce	1	19	19	$14
6	File a formal name application	60	20	79	$30
7	Publish commercial name in newspaper	0	20	79	$0
8	Register in Civil Registry	6	21	26	$165
9	Register with DGII & obtain an ID number	6	27	32	$7
10	Deposit documents in DGII	0	27	32	$0
11	Certify notice of formation with newspaper editor	2	33	34	$0
12	Certify notice of formation with City Council	1	35	35	$4
13	Register publication with Civil Registry	3	36	38	$0
14	Publish formation notice	2	39	40	$22
15	Deposit documents in Civil Court of First Instance	1	41	41	$2
16	Deposit documents in Justice of Peace	1	42	42	$2
17	Register with Chamber of Commerce	1	43	43	$94
18	Register with Department of Labor	1	44	44	$0
19	Register with IDDS	1	45	45	$0
20	Register for occupational accident policy	1	46	46	$0
21	Pick up formal Certificate of Registry	1	80	80	$0
	Totals	***106***	***1***	***80***	***$885***

Source: Database for Djankov et al. (2002).

32. Secondly, both countries require the applicant to publish company information in the newspapers. Depending on the publication frequency of the relevant papers, this is often the one steps that causes most delay in the company registration process. Although in theory such a process may help to weed out bogus companies by way of public scrutiny, its usefulness in practice is less evident. In the Dominican Republic, going through this process is also used to assure the uniqueness of the companies' commercial names. Clearly, better record keeping on the part of the government can easily serve this purpose with much less hassle and expense on the part of the companies.

33. Thirdly, many of the documents to be filed at the various agencies have to be certified or notarized before they can be accepted. This is particularly the case in the Dominican Republic. While it is surely imaginable that some potential companies would present false papers to get registered without the intention to establish an honest business, this is not true for the majority of the investors. For them, as well as the general public , the requirement is purely an additional procedure with limited benefits.

34. Finally, as is common in many developing countries, some seemingly simple procedures are cut up into small pieces, with separate government agencies being responsible for each piece. For example, to obtain an ID number in the Dominican Republic – a procedure that takes a few hours in Canada - an investor has to go through several different agencies in order to obtain the authorization to deposit documents, to deposit documents, to pay for processing the documents, and to pick up the ID number 2 to 10 days later depending on the situation. It is easy to see that streamlining this procedure can be quickly achieved by eliminating some of the steps with little loss to upholding public interests.

35. To sum up, while the purpose of company registration is the same in all three countries – to provide basic information to the authorities about the investment – there exist wide discrepancies in how this is achieved and the burden it creates for the potential investors. Multiplying such discrepancies by the number of procedures that an investor has to go through in the course of normal business, the deterring effect of an inefficient regulatory framework can be enormous.

IV. Supporting Institutions

36. To varying degree, most developing countries have liberalized their economies over the last decades and amended the relevant foreign investment laws with the objective of improving the legal and regulatory environment that governs FDI. However, many of the sound policies and legal reforms "on paper" fail to translate into practical improvements "on the ground" and the inflows of FDI remain low or decreasing in a large number of countries. It is becoming clear that how the FDI policies and regulations are implemented in reality is just as important as the policies and regulations themselves, and that the capacity and efficiency of the supporting institutions are integral parts of an effective regulatory framework for attracting beneficial FDI. These supporting institutions include a free political environment, a competitive market mechanism, a

functioning financial system, adequate transportation and communication channels, and efficient public services.

37. The efficiency of the administrative agencies enforcing foreign investment laws and regulations is directly affected by the clarity and rationality of the underlying rules and regulations. In countries going through substantial legal reforms, poor coordination within the reform process may lead to several new laws with clauses that contradict with each other. As policies and laws are reformed, the associated implementing regulations or normative instructions proliferate, often with a time lag and usually without much consideration about how the implementing regulations associated with one law might interact with the implementing regulations associated with other laws. Such a situation can easily lead to overly complex and redundant procedures that create bottlenecks. For example, it is not uncommon for investors to discover that in order to receive permit A, they need to have authorization B; but to get authorization B, they need to show registration C; however in order to complete registration C, they are officially required to submit a copy of permit A. Such confusing and contradictory regulations may seriously impair the public officials' ability to implement the relevant policies and laws efficiently.

38. The predictability in the application of the laws and regulations – another important component of a good regulatory framework for investment – depends on the capacity of the administrative personnel. As vague regulations often leave considerable discretion to government bureaucrats, how they interpret, implement, and enforce the laws and regulations makes all the difference. Lack of qualified and competent civil servants is a common problem in many developing countries which can only be resolved with the overall improvement of the human capital in the country. Meanwhile, better training in legal concepts and administrative skills, coupled with clearer policies and regulations, may help improve the efficiency with which the administrative agencies delivery public services.

39. Technology can also provide a useful tool by linking together agencies via virtual networks, thus facilitating not only the relations between investors and government's officials but also the coordination within the public administration. There has been a strong push towards institutional reforms – most notably in favor of the so-called "one-stop-shop." Unfortunately, these technological and institutional remedies have generally proved useful to support or complement administrative reforms, but not lead them. That is, unless the underlying laws and regulations and institutions are in place, setting up one-stop-shops do not automatically produce better outcomes.

40. Finally, streamlining administrative procedures often involves changing mentalities and behaviors, which takes time, strong political commitment, and determined actions. Once specific bottle-necks are identified, it is not always easy to remove them. Vested interests in the administration tend to resist change, especially if it means removing their own power and discretion. Even if their job is not jeopardized, as it often is, when reforms remove unnecessary administrative procedures altogether, for many under-paid civil servants, gifts, speed payments and the like may be too attractive

to resist. Corruption in its various forms have been shown to be a major deterrence to FDI inflows.[10]

41. Therefore, while many regulatory procedures are both necessary and beneficial to the overall business environment, how they are administered may make all the difference. Removing redundant administrative barriers to investment does not imply abandoning governmental responsibilities to uphold welfare. However, inefficient, antagonistic, and arbitrary enforcement of business regulations usually lead to substantial delays and costs to the investors, which may drive them to locate elsewhere.

V. How to Promote FDI?

42. International evidence has shown that foreign investors are attracted to a country by three basic factors:[11]

- The "product", or the country itself as an investment site. Some aspects of the product such as location, existence of natural resources, and market size are generally beyond the ability of the government to change. Other factors such as macroeconomic stability, investment regime, and physical and social infrastructure are more under the influence of government policy.

- The "price", or the cost to the investor of locating and operating within the investment site. This includes the cost of accessing land, infrastructure and utilities, the effective cost of taxes and subsidies, and the administrative cost of various regulatory procedures. As discussed at length in the previous section, broad-based, transparent, non-discriminatory, and predictable regulatory framework is a very powerful attraction for a country seeking foreign investments.

- The "promotion", or activities that disseminate information about or attempt to create an image of the investment site and provide services for the prospective investor. Typically, promotional activities aim to capitalize on a country's product and price advantages.

43. It is often argued that only when the "product" and " price" are right can a country truly benefit from a successful promotion effort. As illustrated by the experiences of Singapore, Malaysia and Ireland, investment promotion can be a valuable complement to

[10] See for example Drabek, z. and W. Payne, 1999, "The impact of transparency on foreign direct investment." *Staff Working Paper ERAD-99-02*. Geneva: World Trade Organization; Wei, S. 1999, "Does corruption relieve foreign investors of the burden of taxes and capital controls?", *Policy Research Working Paper 2209*. Washington D.C. World Bank; and Kaufmann, D. and S. Wei, 1999, "Does grease money speed up the wheels of commerce?", *Policy Research Working Paper 2254*. Washington D.C. World Bank.

[11] Wells, L.T. and A. Wint, "Marketing a Country", FIAS Occasional Paper, March 2000.

increase or speed up the inflow of FDI in countries which offer good business environments. At the same time, since one of the most important functions of the investment promotion agency can be to improve the investment climate, "promotion" can help get the "product" and "price" right, hence improving the most fundamental attractiveness of the country. In this section, three instruments that the governments often resort to in order to promote FDI are discussed: investment promotion agencies, investment code, and tax incentives.

A. Investment Promotion Agencies (IPAs)

44. The question of whether and to what degree scarce resources should be allocated to investment promotion is a legitimate one. Many countries, such as Brazil, China and Russia, have done well and will continue to do well attracting FDI without a strong promotion effort. This is especially the case for countries with large domestic markets or natural resources. However, for smaller countries and countries that suffer from a perception gap, where the investment climate is actually better than perceived due to information failure, promotion may help enhance inward FDI. Small countries in particular can benefit from pro-active promotion in order to get on the 'radar screens' of international investors.

45. Yet international experience suggests that most of IPAs are not as successful as the Irish Investment Development Agency or Singapore Economic Development Board at attracting FDI. Even when the country has a good "product" to offer investors, there is a host of strategic and institutional challenges that the government face when trying to establish successful IPAs. Ultimately, policy makers need to give careful consideration to two key issues: (i) the appropriate mix of investment promotion techniques based on a suitable investment promotion strategy, and (ii) the appropriate organizational structure for the investment promotion functions.

46. A suitable promotion strategy will need to address "What to Promote" and "How to Promote." "What to Promote" depends on the investment supply and demand equation, that is, the assets a country realistically has to offer in terms of its investment environment and the business opportunities investors are looking for. Decisions on "What to Promote" are seldom made quickly and are subject to review and adjustment over time.

47. With regard to "How to Promote", a useful framework formulates a balance of four basic functions of investment promotion: image building, investment generation, investor servicing and policy advocacy. The mix of functions depends on the needs of a country at a particular time, the domestic and international economic environment, and resources and priorities of a government. National circumstances should guide the relative emphasis given to one or another and how the mix of these functions should evolve over time.

48. Once an investment promotion strategy has been outlined, careful consideration should be given to the institutional and organizational structure of an IPA. While there is

not one solution to developing an optimal structure, international experiences have contributed to a set of principals that may help an IPA accomplish its goals: an investment promotion organization should have an appropriate governance mechanism, be subject to reporting patterns that encourage its effectiveness and have relationships with other entities that enable it to work with those whose cooperation is needed for it to implement its strategy.

49. A solid legal basis and clearly defined mandate are essential ingredients to an effective IPA. The legal instrument used should provide its authority, powers and control measures. It should define its functions and responsibilities, external structure including linkages with the government and the private sector, the composition and selection process of its board, staffing and reporting arrangements, and how it is to be funded. Best practice shows that the most successful IPAs are statutory bodies, and the strongest of those are established under an act of parliament. Government decisions or decrees, on the other hand, are often weaker because they can be easily overturned, dropped or modified with government or policy changes.

B. Investment Codes

50. During the 20th century many countries, particularly developing and transition economies, have adopted Investment Codes to govern the treatment of FDI within their borders. Some of these laws cover domestic investment as well. Essentially, these special laws are a tool to support the policy towards investments. As such they are as good or bad as the policies they support. At one point in time, when governments were wary about foreign investment, restrictive Investment Codes were used to subject investors to strict controls and restrictions. Nowadays, as most countries have come to recognize the potential benefits of FDI and are trying to improve the regulatory environment in order to attract foreign investments, Investment Codes tend to have a number of guarantees and few restrictions.

51. While Investment Codes provide international investors with increased legal security and transparency, this function is not what distinguishes Investment Codes from other legal instruments. Indeed, many countries around the world - France, Singapore, and the United States are notable examples - do not have an Investment Code per se. Brazil did not have one either throughout the 1950s-70s but was the leading FDI recipient among developing countries nonetheless. This does not mean that these countries do not offer any guarantees or impose any restrictions on foreign investment, but that the guarantees and rules are found elsewhere in the legal framework.

52. Consequently, the chief function of Investment Codes is seen by many as promotional, supporting the Government's strategy to attract FDI. There are at least two obvious benefits which accrue from adopting an Investment Code rather than a series of legislative reforms: from the governments' point of view, preparing one text instead of

revising many can save time and scarce resources;[12] while for prospective foreign investors, it is more convenient to find all the applicable rules and regulations in a single text than to have to review many scattered legislations.

53. However, despite the usefulness of an Investment Code, policy-makers in developing countries should be reminded that it is only one element of a country's legal framework, which forms only one component of the regulatory environment, which in turn constitutes only one dimension of the investment climate. Therefore, although a bad Investment Code - one that lacks certain fundamental guarantees expected by investors - may discourage some investors, a well-written Investment Code by itself will not be sufficient to attract foreign investors.

54. In preparing an Investment Code, attentions should be paid to two dimensions: process and content. In terms of process, the best practices that apply to legal reform in general hold for Investment Codes. They include the adoption of a participatory approach, whereas stakeholders are consulted at critical stages in the process. The drafting itself should occur only after the strategy has been formulated, the various features of the Code agreed upon, and the overall legal framework reviewed to identify possible gaps, overlaps, and risks of conflicts. Local lawyers should assume the drafting responsibility, while external advisers should only provide inputs based on other countries' experiences.

55. In terms of content and recommended features, there is no international consensus on what should be included in an Investment Code that seeks to promote FDI. The reference here remains the World Bank Guidelines of 1992.[13] In general, the guiding principle is "less is more". That is, the Code should strive to be short and clear, restating the guarantees and principles of fundamental importance to investors when they exist or introducing them when they are missing from the legal framework. At the minimum, an Investment Code should guarantee that foreign investors:

- Will not be discriminated against by the host State;
- Will be able to transfer abroad their profits, dividends, and other funds swiftly and freely;
- Will not be expropriated without appropriate compensation; and
- Will be able to resort to international arbitration to settle certain disputes with the host State and/or domestic firms.

56. Beyond these core provisions, an Investment Code can be used to accord investors a wide range of protections depending on the specific country situation. It can also simplify the FDI regime by removing specific bureaucratic hurdles and abrogating the regulations that introduced them. In the case that the country preparing an Investment

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[12] Although it is doubtful that a serious flaw or gap in the overall legal framework can be redressed just be inserting a provision or two in the Investment Code. An expropriation clause in the Investment Code is no substitute for a good expropriation act.

[13] See I.F.I Shihata, "*Legal Treatment of Foreign Investment : The World Bank Guidelines*" (1993) and one of the papers that led to the Guidelines: A. Parra "*Principles Governing Foreign Investment, as Reflected in National Investment Codes*" (1991).

Code also wants to establish an Investment Promotion Agency, the Investment Code can be used to establish such an Agency, its legal status and mandate, leaving operational details to implementing regulations.

C. Tax Incentives

57. When it comes to FDI promotion in a competitive world, governments often turn to special fiscal incentives in order to attract the ever more mobile multinational companies. Although this phenomenon is hardly new, its popularity seems to have grown considerably since the early 1990s. The common practices range from tax holidays and import duty exemptions in poor African countries to investment allowances and accelerated depreciation in industrial countries. But have tax incentives been able to attract foreign investments? And what are the costs associated with the use of tax incentives?

58. The general consensus here is that these incentives are not the most influential factor in the location choices of foreign investors. Numerous surveys of international investors and time-series econometric analysis have confirmed this conclusion over the past few decades. However, looking at FDI figures, it is certainly not a coincidence that flows to tax haven countries in the Caribbean and South Pacific grew more than fivefold between 1985 and 1994 while the total world FDI flows tripled. Ireland’s tax policy has been generally recognized as a key factor in its success in attracting international investors over the past two decades. Therefore, in more recent years, there is a growing acknowledgment that tax incentives do affect the decisions of some investors some of the time.

59. There are four main instruments that the governments can use to influence the effective tax rates and the location decision of multinational companies: (i) a low statutory corporate income tax rate; (ii) tax holidays; (iii) investment tax allowances; and (iv) tax heaven or Export Processing Zones. Each of these approaches has its pros and cons, and their effectiveness is likely to depend on the country’s investment need, as well as the multinational firm’s activity and its motivations for investing abroad. Small countries such as Lebanon and Mauritius, for example, have typically opted to have a generally low statutory tax rate. This signals that the government is interested in letting the market determine the most profitable investments without undue governmental influence, and has been looked upon favorably by international investors. Yet, it has to be recognized that this approach may reduce tax revenues at least during a transition period even though the simplicity of the tax system should attract further investment and increase the tax base in the long run.

60. Among the more selective approaches, tax holidays and tax heavens are the most popular forms of incentives around the world, especially the emerging countries where authorities have favored a discretionary approach. Although such incentives provide immediate and large advantages to the benefiting firms, besides causing considerable erosions of the tax base and tax revenues, they attract primarily short-term investments and reward mainly the founding of a company rather than company expansions. There is

a growing evidence that this type of tax incentives seem to be a crucial factor for mobile firms or firms that operate in multiple markets such as Internet related business, insurance companies and banks because they can exploit better the different tax regimes across countries. Export-oriented companies are also more sensitive to such tax incentives than those seeking domestic markets because they not only are more mobile but also operate in highly competitive markets with very slim margins.

61. In the developed world, fast write-offs for investment expenditures - either all investments, or those they especially want to induce through tax allowances or credits – are enjoying increasing popularity.[14] Investment tax allowances have distinct advantages, as it encourages companies to take a long-term view when planning investments and represents a non-discretionary regime which does not depend on case-by-case evaluations. Still, they have serious limitations and drawbacks, especially for projects with long gestation periods and in unstable macroeconomic environment, where the value of the tax allowances may be eroded quickly. They are also relatively difficult to manage for tax administration and require well-developed accounting systems.

62. Regardless of the approaches, all tax incentives are costly. The first and most direct costs are those associated with the potential loss of revenues for the host government. The argument here is to determine if the new foreign investment would have come to the country if no or lower incentives were offered. In some Asian countries, for example, the redundancy rate is found to be over 80 percent. In such cases, "free rider" investors benefit, the Treasury loses, and there is no net benefit to the economy.

63. In addition, tax incentives have many less evident costs: inefficient allocation of resources through distorted investment decisions by private companies; attracting the "wrong kind" of foreign investors when the fundamentals are not yet in place; exacerbation of the "race to the bottom" by creating a bidding war between countries or regions; and increased administrative burden and opportunities for suspicious behaviors from public officials where granting of incentives are discretionary.

64. In summary, one has to keep in mind that successful examples of using targeted tax incentives to attract FDI like Singapore or Ireland are rare. In fact, more and more evidence is emerging to suggest that multinationals give more importance to the simplicity and stability of the tax system in a country than generous tax rebates, especially in an environment with great political and institutional risks.[15] This is why the recent trend has been to eliminate and streamline tax incentive programs.

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[14] These allowances take three forms: (1) accelerated depreciation, which allows companies to write off capital more quickly for tax purposes than for accounting; (2) an investment expenditure allowance that lets companies write off a percentage of qualifying investment expenditures from their taxable income; and (3) an investment tax credit that allows companies to reduce taxes paid by a percentage of investment expenditures.

[15] Ernest & Young (1994), *Investment in emerging markets: a survey of the strategic investment of global 1000 companies*, New York.

ANNEX

Company Registration Procedures in Canada, Morocco, and the Dominican Republic [16]

Canada:

1) Incorporate the company. Register with the Corporations Directorate, Industry Canada under the Canada Business Corporation Act (CBCA). The Directorate issues a certificate and the company may begin operations on the date specified on the certificate. Documents to be filed: NUANS, articles of incorporation, notice of registered office, notice of directors. No proof of the truthfulness is required for any of these statements. It takes 1 day to fill out the forms and costs C$ 330, but the registration certificate comes in 1-2 weeks via internet or 4-6 weeks by mail.

2) Register for a business number. This procedure creates a number for tax and employer purposes, as well as a master business license. It covers four major business accounts with the government: corporate income tax, import-export accounts, payroll deductions, and goods and services tax (GST, i.e VAT). The master business license covers sales tax and health tax. It takes 1 business day (trivial) to complete the step and costs C$ 70 (C$60 by internet or C$80 by mail).

Morocco:

1) Obtain a certificat negatif which registers the company name at the Administration of Industrial Property. It takes 1 business day and costs DH 151 (DH 21 in stamps, DH 30 for search, DH 100 for the certificate)

2) Pay registration tax and stamp bylaws with the Ministry of Finance, Subdivision Polyvalent des Impots. It takes 1 business day and costs at least DH 1350 (DH150 register fees for three copies of Declaration of Conformity, DH 200 stamp costs, and 0.5 percent of capital, which has a minimum requirement of DH 100,000.

3) Deposit paid-in capital in a bank and obtain an attestation de depot. The capital remains frozen until the company formation is complete. The applicant files a copy of bylaws with the bank. It takes 1 business day and it is free.

4) Deposit bylaws at the Registrar of Companies, Tribunal of Commerce and obtain a deposit certification. It takes 1 business day and costs DH 200.

5) Obtain "patente" tax number at the Ministry of Finance, Subdivision Polyvalent des Impots. The applicant files a letter requesting registration, a copy of bylaws with certification that it has been filed at the Tribunal, a copy of the minutes of the

[16] The following three country examples are from the database of Djankov et al. op. cit.

inaugural meeting and the lease contract of the property rented for premises. It takes 1 business day and it is free.

6) Publish company information in the Gazette Official. This must be done within a month following company construction. It takes 30 business days and costs DH 400.

7) Publish company information in a national legal paper. This must be done within a month following company construction (simultaneous with procedure 6). It takes 14 business days and costs DH 400.

8) Register at the Tribunal of Commerce. This must done within 3 months following company construction. The applicant files 3 copies of stamped declaration d'immatriculation, original of the "patente" form 1220, the newspaper containing the notice of opening, copy of the certification of bank deposit of capital, and the copy of the certificat negatif. It takes 1 business day and the fees are included in procedure 2.

9) Get approval to hire workers from the local Bureau de Placement. It takes 1 business day and it is free.

10) Register the company and each new employee with Caisse National Securite Sociale. This must be done within 6 months of hiring. It takes 1 business day and it is free.

11) File Declaration of Existence at the Ministry of Finance, Subdivision Polyvalent des Impots. The applicant files Declaration of Existence (a form), registry of commerce information, social security registration, the patente, and the lease contract, as well as the application for each tax: corporate income tax, general income tax (withholding tax), VAT, etc.. Income tax registration be done within a 3 month period following formation of the company. VAT registration must be done 1 month after starting operations. It takes 2 business days and it is free.

12) Prepare declaration for the labor inspector (Ministry of Labor), by mail or in person. Also file a work schedule with them. It takes 1 business day (trivial) and it is free.

13) Obtain administrative authorization ("authorization d'exercer" and "reglementation des etablissements incommodes et insalubles") to begin activities at the local Prefecture. The applicant files a letter of solicitation, a copy of patente, a copy of the bylaws, a map of the establishment, installations, fire controls, waste treatment, etc. It takes 15 business days and it is free.

The Dominican Republic:

1) Deposit the 10 percent of the paid-in capital in the bank. It takes 1 business day and it is free.

2) Notarize a sworn declaration of receipt of the payments. It takes 1 business day and costs RD$ 3,700.

3) Hire a certified public accountant. The tax law requires that all companies with authorized capital that exceeds RD$50,000 must submit to the Income Tax Department a financial statement certified by a public accountant. It takes 1 business day and costs RD$ 5,000.

4) Register company name with the Secretaria de Estado de Industria y Comercio and obtain a Certificate of Availability. It takes 15 business days and costs RD$ 51.25.

5) Obtain a receipt from the Chamber of Commerce after paying for the name publication. It takes 1 business day and costs RD$ 220.

6) File a formal name application to the local Secretaria de Estado de Industria y Comercio. If there is no opposition from third parties, the applicant has 30 days to apply for a formal Certificate of Registry with the receipt from the Chamber of Commerce. It takes 60 business days (median of 45 - 75 days), depending on the publication of commercial names in nationally circulated newspapers (procedure 7) and costs RD$ 480.

7) Publish the commercial names monthly in national newspapers. The time delay and costs are included in procedure 6.

8) Pay tax and register documents in Registro Civil. Documents to be filed: articles of incorporation, list of shareholders, minutes of the shareholders meetings, evidence that the capitalization tax has been paid, and notice of formation to be published. It takes 6 business days (simultaneously with procedure 6) and costs at least RD$ 837, which corresponds to the minimum capital requirement of RD$ 10,000.

9) File certified financial reports to the Direccion General de Impuestos Internos (DGII) and obtain an identification (RNC) number. Documents to be filed: certified agreement/memorandum of incorporation, certified bylaws, registered name, evidence of official address, minute of shareholders appointing the directors, bank certificate, and internal Revenue stamps. It takes 6 business days (median of 2 - 10 days) and costs RD$ 110.

10) Obtain an authorization for the deposit of documents and deposit documents at the DGII. This is required by la Seccion de Impuestos a la Propiedad y Obsequios del Departamento de La Direccion General de Impuestos Internos. It takes place concurrently with procedure 9 and the costs are included in procedure 9.

11) Certify the notice of the formation with the editor of a nationally circulated newspaper. It takes 2 business days (simultaneously with procedure 6) and the costs are included in procedure 10.

12) Certify the notice of the formation with the Ayuntamiento. It takes 2 business days (simultaneously with procedure 6) and costs RD$ 60.

13) Register publication with the Oficialia Civil. It takes 3 business days (simultaneously with procedure 6) and it is free.

14) Publish the formation notice in the newspaper. It takes 2 business days (simultaneously with procedure 6) and costs RD$ 350.

15) Deposit company documents with the Secretaria de la Camara Civil y Comercial del Juzgado de Primer Instancia. Documents to be filed: company bylaws, list of subscribers, tax payment receipt, copy of the notarized statement, list of shareholders, an authorization from the DGII, and copy of newspaper publication. It takes 1 business day (simultaneously with procedure 6) and costs RD$ 30.

16) Deposit company documents with the Juzgados de Paz in the company's jurisdiction. Documents to be filed: as above. It takes 1 business day (simultaneously with procedure 6) and costs RD$ 30.

17) Register with the local Registro Mercantil of the Chamber of Commerce and Production. The applicant needs to present the company incorporation documents. It takes 1 business day (simultaneously with procedure 6) and the costs depend on the capital.

18) Register local employees with the Department of Labor. Documents to be filed: a list of permanent personnel to be hired, for which the corresponding forms need to be filled out (these forms can be found at local Internal Revenue offices or Department of Labor), and a chart of the work schedule of all personnel. It takes 1 business day (simultaneously with procedure 6) and it is free.

19) Register employees at the main social security office (IDDS). This must be done within six days of hiring or upon the start of business. It takes 1 business day (simultaneously with procedure 6) and it is free.

20) Register employees for occupational accident policy. This is required for companies with three or more workers. It takes 1 business day (simultaneously with procedure 6) and it is free.

21) Pick up the final Certificate of Registry from the Secretaria de Estado de Industria y Comercio. It takes 1 business day and it is free.

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