International Investment Perspectives

2003

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International Investment Perspectives

2003 Edition

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Note by the Editor

International Investment Perspectives *is an annual publication. Each issue includes an update of recent trends and prospects in international direct investment and provides analyses of investment policy questions of topical interest. Articles are based principally on contributions by the OECD Secretariat and committee reports which have been developed within the framework of the activity programmes of the OECD Committee on International Investment and Multinational Enterprises and the Committee on Capital Movements and Invisible Transactions.* International Investment Perspectives *also offers a tribune for the business, labour and civil society partners of the OECD and other external contributors.*

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Chapter 1

Trends and Recent Developments in Foreign Direct Investment*

Foreign direct investment in OECD countries fell 20 per cent in 2002, following already steep declines the previous year. Preliminary indications point to a further drop in 2003. A total of USD 490 billion in investment flowed into OECD countries in 2002, down from USD 615 billion in 2001 and about one-third the level recorded in 2000. The continued global economic slump, relatively weak stock markets, uncertainties over international security, and heavy debt loads in once-booming sectors like telecommunications all contributed to the decline.

The drop was concentrated mainly in the United States and the United Kingdom. FDI flows into other OECD countries, taken as a whole, remained about flat in 2002. Based on mergers and acquisitions data for the first five months of the year, OECD countries could be heading for a further drop in FDI in 2003 of 25 to 30 per cent.

In contrast, investment flowing out of the 30 OECD member countries showed a more modest decline. Outward FDI hit USD 609 billion in 2002, down from USD 690 the prior year. Developing countries were consequently major beneficiaries of net outflows from OECD countries. For the first time ever, China became the world's largest recipient of FDI in 2002 with total inflows of USD 53 billion.

* This article was prepared by Hans Christiansen and Ayse Bertrand of the Capital Movements, International Investment and Services Division. Thanks are due to Thomas Hatzichronoglou of the Directorate for Science, Technology and Industry for substantial inputs to the last section of the article.

1. FDI and the global economic slowdown: recent trends

FDI remains subdued amid macroeconomic weakness

Foreign direct investment (FDI) in the OECD area has cooled considerably since the investment boom of the late 1990s. The continued sluggishness of the global economy in combination with weak equity prices has already weighed down on FDI flows for a couple of years. However, a number of additional factors appear to be exerting fresh downward pressure on cross-border investment. For example, an increasing number of financial market participants have expressed fears of deflationary pressures in some of the largest OECD economies, contributing to rising uncertainty about the macroeconomic outlook and the future course of monetary policy.

Uncertainty is a second factor

The feeling of uncertainty was further exacerbated in the first months of 2003 by the unsettled international political and security environment. Given the fact that transparency and predictability tops most surveys of the factors that are important to direct investors, it was probably inevitable that FDI activity would decline in 2002 and continue to decline into the first half of 2003. However, as geopolitical tensions recede, the outlook is for a gradual recovery of investor confidence.

And sector-specific concerns are a third

Some sectoral developments also appear to have played a role in dampening direct investment activity. Certain sectors (*e.g.* the airline and tourism industries) are directly hit by the unsettled international situation. Others, such as certain of the "new economy" service sectors that were at the centre of much cross-border investment in the late 1990s, are now burdened with sizeable debts and those involved in them have turned their attention from cross-border takeovers to consolidation. On the other hand, restructuring of the sector is well under way in many countries and the underlying demand for "new economy" services appears to be strong, which should lead to an eventual upturn in investment.

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1.1. Further declines in OECD countries' FDI

FDI inflows to OECD countries fell by 20 per cent in 2002

FDI to and from the OECD countries continued to decline in 2002. FDI inflows into the OECD area dropped from 614 billion US dollars (USD) in 2001 to USD 490 billion in 2002 (Table 1) – a decline of more than 20 per cent. FDI

Table 1. **Direct investment flows to and from OECD countries: 1999-2002**
(USD billion)

	Outflows				Inflows			
	1999	2000	2001p	2002e	1999	2000	2001p	2002e
Australia	0.7	0.6	11.0	6.8	2.9	13.0	4.0	14.0
Austria	3.3	5.7	3.5	5.4	3.0	8.8	6.1	1.7
Belgium/Luxembourg	132.3	218.4	100.6	. .	142.5	221.0	84.7	. .
Belgium	. .	. .	. .	13.3	. .	. .	. .	18.3
Luxembourg	. .	. .	. .	154.1	. .	. .	. .	125.7
Canada	15.6	47.5	35.5	27.9	24.4	66.6	27.5	21.4
Czech Republic	0.1	0.0	0.2	0.2	6.3	5.0	5.6	8.4
Denmark	16.9	25.0	13.0	4.9	16.7	32.8	11.5	6.0
Finland	6.6	24.0	8.4	9.8	4.6	8.8	3.7	9.2
France	126.9	177.5	93.0	62.6	46.5	43.3	52.6	48.2
Germany	109.6	56.9	42.1	24.6	55.8	203.1	33.9	38.1
Greece	0.6	2.1	0.6	0.7	0.6	1.1	1.6	0.0
Hungary	0.3	0.6	0.3	0.3	2.0	1.7	2.6	0.9
Iceland	0.1	0.4	0.3	0.2	0.1	0.2	0.2	0.1
Ireland	6.1	4.6	5.9	2.7	18.5	26.5	15.7	19.0
Italy	6.7	12.3	21.5	17.1	6.9	13.4	14.9	14.6
Japan	22.8	31.5	38.4	32.3	12.7	8.3	6.2	9.3
Korea	4.2	5.0	2.4	2.7	9.3	9.3	3.5	2.0
Mexico	. .	. .	4.4	1.0	12.9	15.5	25.3	13.6
Netherlands	57.6	73.5	48.5	26.3	41.2	60.3	51.2	29.2
New Zealand	1.1	0.6	0.7	0.3	0.9	1.3	4.0	0.3
Norway	6.3	8.3	–0.7	4.8	8.3	5.9	2.1	0.8
Poland	0.0	0.0	–0.1	0.3	7.3	9.3	5.7	4.1
Portugal	3.2	7.5	7.6	3.5	1.2	6.8	5.9	4.3
Slovak Republic	–0.4	0.0	0.1	0.0	0.4	2.2	1.3	4.0
Spain	42.1	54.7	33.1	18.5	15.8	37.5	28.0	21.2
Sweden	21.9	40.6	6.6	10.9	60.9	23.2	11.8	11.1
Switzerland	33.3	44.7	17.3	11.8	11.7	19.3	8.9	9.3
Turkey	0.6	0.9	0.5	0.2	0.8	1.0	3.3	1.0
United Kingdom	202.3	255.2	68.1	39.7	89.3	119.7	62.0	25.0
United States	188.9	178.3	127.8	123.5	289.5	307.7	130.8	30.1
Total OECD	**1009.7**	**1276.5**	**690.4**	**606.4**	**893.0**	**1272.6**	**614.5**	**490.6**

Notes: data are converted to US dollars using average exchange rates. p: preliminary; e: estimate.
Source: OECD International Direct Investment Database.

outflows also declined, albeit at a slightly more modest pace. In 2002, they stood at USD 607 billion, compared with USD 690 billion the year before, a fall of 12 per cent. OECD countries' traditional role as net providers of direct investment to the rest of the world was buttressed. Net FDI flows to non-member economies reached USD 117 billion in 2002, up from USD 76 billion in 2001 and USD 4 billion in 2000.

A sharp drop in investment into United States and United Kingdom

The United States and United Kingdom accounted for the entire decline in OECD-wide inflows between 2001 and 2002. These two countries, traditionally the largest recipients of FDI within the OECD area, saw their inflows fall by a combined USD 138 billion. Inflows into the United States in 2002 at USD 30 billion were puny by past standards (and represented a decline of 77 per cent relative to 2001). This reduced the United States to the status of fourth-largest FDI recipient after having dominated the league table for a decade. Inflows into the United Kingdom fell from USD 62 billion in 2001 to USD 25 billion in 2002 – or a 60 per cent decline.

United States has become a net FDI exporter

By contrast, FDI outflows from the United States have held up rather well. In 2002, total outflows stood at 123.5 billion, down by only USD 4 billion from the year before. As a result, the United States' previous role as a net importer of FDI was reversed, with the country providing net direct investment to the rest of the world to the tune of more than USD 90 billion.

OECD countries other than the United States and United Kingdom recorded a total increase in FDI inflows of USD 14 billion (or 3 per cent) in 2002. However, significant country differences underlay this increase. Some stylized observations offer themselves (see also Figure 1).

Several smaller countries recorded large increases in their inflows of FDI

- The countries that saw the largest relative declines in direct investment inflows in 2002 were New Zealand (93 per cent), Austria (73 per cent), Hungary, Norway and Turkey (all three more than 60 per cent) and Denmark, Korea and Mexico (between 40 and 50 per cent).
- Some countries attracted more investments in 2002 than they did at the height of the FDI boom 2000 (when total inflows into the OECD area reached an all time high of USD 1.273 trillion). For example, inflows to Australia rose to 14 billion, the highest level on record since the early 1990s. Likewise

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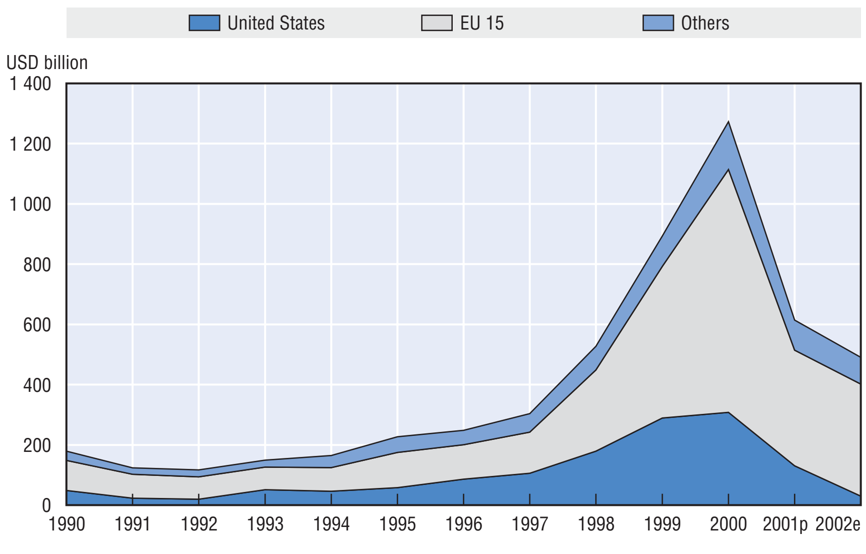
Figure 1. **Total FDI inflows to OECD countries**



Source: OECD International Direct Investment Database.

inflows rose significantly in 2002 into the Czech Republic (to USD 8 billion), the Slovak Republic (to USD 4 billion) and Finland (to USD 10 billion).

Outflows originated largely in a handful of big OECD countries

- Foreign direct investment into Japan increased between 2001 and 2002 (to USD 9 billion) but they remained somewhat below the all-time high of USD 13 billion that was recorded in 1999.
- The main providers of outward FDI in 2002, apart from the United States and United Kingdom, were Luxembourg[1] (USD 154 billion), France (USD 63 billion), Japan (USD 32 billion), Canada (USD 28 billion) and the Netherlands (USD 27 billion).
- The countries with the largest relative drops in FDI outflows in 2002 were France, Germany, Spain and the Netherlands (all of which saw declines exceeding 40 per cent). Among the other large economies, Japan and Canada also recorded declining outward FDI in 2002, but at more modest rates of 16 and 21 per cent, respectively.

On a net basis, the OECD area remains the world's main provider of FDI

Taking a slightly longer perspective, the role of OECD countries as the world's foremost provider of direct investment funds is well established. Net outflows from the OECD area reached USD 876 billion over the last decade (1993 to 2002 – see Table 2). The United Kingdom, France, Japan, Switzerland and Germany have been the OECD's main net exporters of FDI. By contrast the United States – which is by far the top country both as an investor and a

Table 2. **Cumulative FDI flows in OECD countries 1993-2002**
(USD billion)

Inflows		Outflows		Net outflows	
United States	1 284.5	United States	1 220.8	United Kingdom	407.0
Belgium/Luxembourg	682.4	United Kingdom	891.5	France	312.0
United Kingdom	484.5	France	634.4	Japan	208.8
Germany	393.8	Belgium/Luxembourg	680.3	Switzerland	118.2
France	322.4	Germany	489.7	Germany	95.8
Netherlands	272.5	Netherlands	346.8	Netherlands	74.4
Canada	206.1	Japan	253.2	Spain	44.2
Sweden	167.9	Canada	223.5	Italy	37.2
Spain	152.7	Spain	196.9	Finland	38.3
Mexico	128.6	Switzerland	191.5	Canada	17.4
Ireland	97.2	Sweden	141.3	Norway	3.6
Denmark	88.9	Italy	110.5	Portugal	0.7
Italy	73.3	Finland	83.6	Iceland	0.3
Australia	74.9	Denmark	79.4	Greece	–5.6
Switzerland	73.3	Australia	44.0	Korea	–2.4
Poland	49.4	Norway	38.7	Turkey	–7.6
Finland	45.2	Korea	35.5	Austria	–8.1
Japan	44.3	Portugal	29.4	Denmark	–9.5
Korea	37.9	Austria	28.2	Slovak Republic	–9.6
Austria	36.3	Ireland	26.4	New Zealand	–19.2
Czech Republic	35.9	Mexico[1]	5.4	Hungary	–20.1
Norway	35.1	Turkey	3.1	Belgium/Luxembourg	–2.1
Portugal	28.7	New Zealand	2.7	Sweden	–26.5
Hungary	22.7	Hungary	2.5	Australia	–30.9
New Zealand	21.9	Iceland	1.3	Czech Republic	–34.9
Turkey	10.7	Czech Republic	1.1	Poland	–48.6
Slovak Republic	9.6	Poland	0.8	United States	–63.8
Greece	9.3	Greece	3.7	Ireland	–70.8
Iceland	1.0	Slovak republic	0.1	Mexico (1)	–123.2
TOTAL OECD	**4 891.1**	**TOTAL OECD**	**5 766.2**	**TOTAL OECD**	**875.1**

1. Based on outflow data for 2001 and 2002 only.
Source: OECD International Direct Investment Database.

recipient of FDI – has been among the main net recipients in the OECD area, second only to Ireland.

1.2. Strong activity among some non-member economies

Flows to some non-member countries have held up well in recent years

The FDI flows to several developing countries have held up much better than OECD area inflows, and in some cases have even risen in recent years. FDI inflows in non-member countries adhering to the OECD Declaration on International Investment and Multinational Enterprises were halved between 2000 and 2002 (Table 3). This decline is less than what was experienced by an average OECD economy over the same period, which is particularly

Table 3. **Direct investment flows to selected non-OECD countries: 1997-2002**
(USD billion)

	1997	1998	1999	2000	2001p	2002e
Adherents to the OECD Declaration:[1]						
Argentina	9.2	7.3	24.0	11.7	3.2	0.4[3]
Brazil	19.7	31.9	28.6	32.8	22.6	19.2[4]
Chile	5.3	4.6	8.8	3.6	4.5	1.6
Estonia	0.3	0.6	0.3	0.4	0.5	0.3[3]
Israel [2]	2.0	1.8	3.1	5.0	3.3	1.6
Lithuania	0.4	0.9	0.5	0.4	0.4	0.8
Slovenia	0.3	0.2	0.1	0.1	0.5	1.9
Total	37.0	47.4	65.3	54.0	35.1	25.8
Other non-member economies:						
China	44.2	43.8	38.8	38.4	44.2	52.7[5]
Hong Kong, China	. .	14.8	24.6	61.9	22.8	13.7[6]
Indonesia	4.7	–0.4	–2.7	–4.6	–3.3	–2.3
Malaysia	5.1	2.2	3.9	3.8	0.6	. .
Singapore	10.7	6.4	11.8	5.4	8.6	. .
Russia	4.9	2.8	3.3	2.7	2.5	2.4
South Africa	3.8	0.6	1.5	1.0	7.3	0.7

p: preliminary; e: estimate.
1. Countries adhering to the OECD Declaration on International Investment and Multinational Enterprises.
2. Source: Central Bank of Israel.
3. Secretariat estimate based on the first three quarters of the year.
4. Secretariat estimate based on the first half of the year.
5. Source: Chinese Ministry of Commerce.
6. Source: Hong Kong Census and Statistics Department.

Source: IMF Balance of Payments Statistics, unless otherwise stated.

remarkable since the non-member Adherents include three South American countries (Argentina, Brazil and Chile) that were affected by the fallout from the financial crisis in Argentina. In 2002 two former transition economies (Lithuania and Slovenia) saw their FDI inflows rise.

China has become the world's foremost recipient of FDI

Among other non-member countries, inflows into China (mainland) have been particularly impressive. According to national sources they stood at almost USD 53 billion in 2002 – their highest level ever – making China the world's largest recipient of FDI (at least when the notoriously volatile data for Luxembourg are disregarded). Judging from preliminary data for the first four months of 2003, significant further increases are likely this year.

Hong Kong (China) is another major recipient of FDI flows (albeit often in connection with investment projects in mainland China), which however saw its inflows drop sharply in 2001 and 2002. Since the mid-1990s, Russia has tended to attract FDI to the tune of USD 2-3 billion per year, a trend that was confirmed in 2002 and appears likely to continue in 2003, judging by data for the first three months. Finally, direct investors continued disengaging from Indonesia in 2002. The total amount of disinvestment was USD 2.3 billion, down from USD 3.3 billion the year before.

1.3. Mergers and acquisitions in the first half of 2003: an indication of things to come?

M&A data can provide an indication of FDI, but must be interpreted with caution

Mergers and acquisitions (M&As) are the largest single component of FDI in most OECD member countries,[2] and unlike official FDI figures M&A data can be obtained on a weekly basis from private data providers. Thus, cross-border M&A data can be used to shed some light on the likely trends in FDI in the first half of 2003. The downside is that such data is generally not fully consistent with official sources (for instance, they tend to be more inclusive in the types of transactions they consider as "investment"). Therefore, direct comparisons between the data presented in the present sub-section and the official FDI data quoted elsewhere should be avoided.[3]

According to data provided by Dealogic, cross-border M&As in OECD countries during the first five months of 2003 fell to the lowest level since the mid-1990s. Both inflows and outflows were less than half of the levels recorded in the same months of 2002, and in both cases the declines reflect a falling number of transactions as well as a smaller average deal size.

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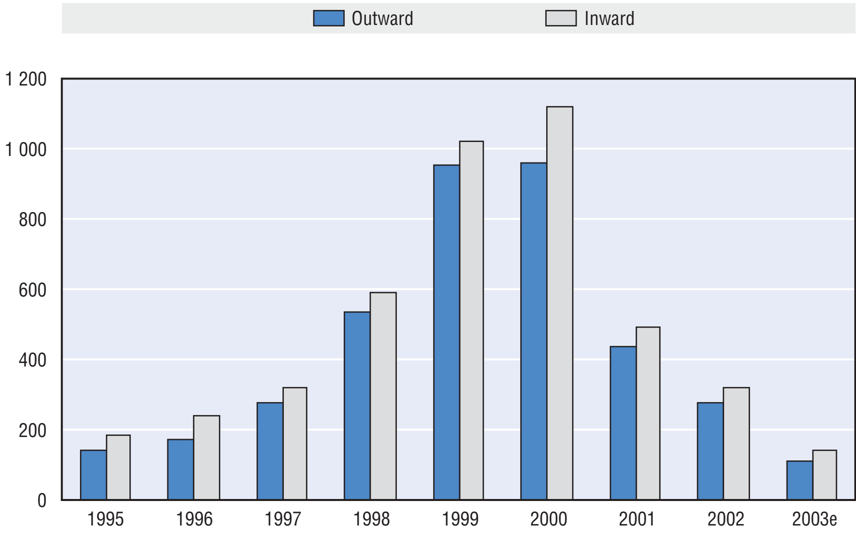
Cross-border M&A in early 2003 show that activity has more than halved since the year before

Assuming that the levels of M&A do not recover from the present low levels, 2003 will be a year of very low cross-border M&As by past historic standards (Figure 2). On an annual basis, the January-May figures correspond to a total OECD inflow of USD 140 billion in 2003 and an outflow of USD 115 billion. Both figures are around one eighth of the corresponding flows recorded only three years earlier Without getting into a detailed breakdown of the trends by countries, it is nevertheless fair to say that the declines have affected most of the large OECD countries. The preliminary data suggest that all the most important economies in Europe and North America saw their FDI inflows through the M&A channel dwindle in the first months of 2003.

There could be further declines in FDI this year

This, in turn, indicates that on present trends FDI in OECD countries is set to decline further in 2003. Total FDI flows are, however, considerably less volatile than cross-border M&As, so they are unlikely to show declines of a similar magnitude. The estimated linear relationships between FDI and cross-

Figure 2. **Cross-border M&As, total OECD area**



e: estimate.

Source: Dealogic.

border M&As over the last decade suggest that (again on present trends) FDI into the OECD area in 2003 could decline by as much as 25 to 30 per cent. By the same measure, FDI outflows would drop by about 20 per cent. If borne out by facts, the 2003 FDI flows into and out of OECD countries would stand at around one third of the levels of the peak years 1999 and 2000, but still above the FDI flows recorded in the mid-1990s.

2. Individual transactions in 2002 and early 2003

Fewer and smaller transactions in 2002 and early 2003

In the process of sharply declining cross-border investment, individual transactions have not just become fewer they have also become smaller on average. In 2002 and early 2003, only eight cross-border M&As involved bid values in excess of USD 5 billion, and the largest individual transaction was valued at around USD 14 billion. In the late 1990s and 2000, corporate takeovers worth tens of billions of dollars happened virtually every month.

2.1. The OECD area: What sectors, what investors?

There was still non-negligible activity in the telecom sector

Some of the largest cross-border mergers and acquisitions into OECD countries during the period under review took place in the *telecommunications* sector. The largest individual transaction was France Telecom's investment of USD 7.1 billion into the troubled German mobile telephony provider Mobilcom. Among the other major investments in this sector was the acquisition of the Finnish telecom operator Sonera Oyj by Telia of Sweden for USD 5.8 billion, the USD 2.3 billion purchase of 22.5 per cent of the shares in German E-Plus Mobilfunk by Koninklijke of the Netherlands and Deutsche Telekom's sale of its six remaining regional cable TV networks to an international investor group for USD 2.3 billion.

Energy production and distribution also held up

Another sector that saw much cross-border investment activity in 2002 and early 2003 was *energy production and distribution*. The United Kingdom figured prominently in this respect. For example, the UK oil producer Enterprise Oil was taken over by Royal Dutch/Shell for USD 5.0 billion, and the power and gas generator Innogy Holdings was bought by German RWE for

USD 4.4 billion. TXU Europe Group sold its retail business to Powergen, which is a subsidiary of E.On of Germany, for USD 2.5 billion and the electricity distributor Seeboard was taken over by Electricité de France for USD 2.0 billion.

Furthermore, the largest individual transaction into the former transition economies was the privatisation sale of 49 per cent of the shares in the Slovakian natural gas utility Slovensky Plynarensky Priemysel. The shares were auctioned off to an international consortium consisting of Gaz de France (France), Ruhrgas (Germany) and Gazprom (Russia) for 2.7 billion.

Less activity in utilities and finance

The *utilities* sectors (apart from the segments already mentioned) were not the target of similarly massive individual takeovers as in the past, but a couple of privatisation sales to foreign investors nevertheless bear mentioning. 12.5 per cent of East Japan Railway Company and 44.2 per cent of the French toll road operator Autoroutes du Sud de la France were sold off to international investor groups. The value of the transaction was in both cases USD 2.1 billion.

The *financial* sector recorded the largest individual transaction during the period under review, namely the estimated 14.5 billion that HSBC Holdings of the United Kingdom paid for the US consumer finance group Household International. Other major investment included Bank of America's USD 1.6 billion purchase of 24.9 per cent of the Mexican banking group Grupo Financiero Serfin, and the acquisition of the UK First National Consumer Finance by General Electric of the United States at a price of around USD 1.4 billion.

Among the more "traditional" industries, food and beverages scored well

Among the more traditional industries, the *food and beverages* sector saw several large cross-border transactions in 2002 and early 2003. Among the largest was South African Breweries' USD 5.5 billion purchase of the US brewery group Miller Brewing from Philip Morris and Cadbury Schweppes' USD 4.2 billion purchase of Adams Confectionery Business from Pfizer Inc, likewise from the United States. Both the acquiring enterprises are domiciled in the United Kingdom. Another big M&A was the purchase of 90 per cent of the shares in German tobacco manufacturer Reemtsma Cigarettenfabrik for USD 4.6 billion by the UK Imperial Tobacco Group. Finally, Nestlé of Switzerland took control of the US frozen-food producer Chef America for USD 2.6 billion.

M&As in mining and mineral extraction have cooled

The *mining and mineral extraction* sector, which is traditionally active in repositioning itself internationally, recorded relatively few and limited cross-border M&As during the period under review. Among the exceptions was Xtrata of Switzerland, purchasing the Australian/South African coal mining company Glencore International for USD 2.5 billion and the USD 1.0 billion acquisition of German Preussag Energie by Gaz de France.

Finally, the *pharmaceuticals* industry saw a few sizable international transactions in 2002 and early 2003. The sell-off of the Swiss company Roche Holding's vitamins and fine chemicals division for USD 1.9 billion to DSM of the Netherlands was the largest, followed by the USD 1.5 billion paid by Merck and Co. of the United States for 49.1 per cent of the shares in Japan's Banyu Pharmaceutical Company.

2.2. Important deals outside the OECD area

Non-member countries saw a few large takeovers

By far the largest individual transaction into a non-OECD country in the period under review was recorded in China, where China Mobile of Hong Kong (China) paid USD 10.2 billion for the mobile phone operator Anhui Mobile Communication. Other large transactions included the sale of Panamerican Beverages of Panama to the Mexican corporation Fomento Economico Mexicano for USD 2.7 billion.

Finance and mining were among the top sectors

The financial sector in Hong Kong (China) was the target of a couple of large cross-border transactions. One was the acquisition of 21.7 per cent of the shares in the commercial bank BOC Hong Kong Holdings by an international group of investors for USD 2.5 billion. Another was the sale of 28.4 per cent of DBS Diamond Holdings (the owner of Dao Heng Bank) to DBS Group Holdings of Singapore.

In the mining and mineral extraction sectors, 17.8 per cent of the metal producer Companhia Vale do Rio Doce SA of Brazil was purchased by an international group of investors, and Lukoil of Russia sold the Azeri-Chirag-Guneshli oil field to INPEX Corporation of Japan for USD 1.4 billion.

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3. Spotlight on the high-tech sectors

M&As between high-tech companies attracted much attention in the late 1990s

During the boom in FDI in the late 1990s and 2000, much of the attention focused on the high-tech sectors. Knowledge-based enterprises – particularly the information and communication technology (ICT) companies of the so-called "new economy" – saw their market valuations increase sharply during the equity price boom. On top of this, privatisation and liberalisation in the telecommunication sectors of a range of OECD countries led to a deepening of the relevant segments of the markets for corporate control. Both of these factors contributed to a wave of corporate restructuring within the high-tech sectors. Corporate entities were actively traded between rival conglomerates, including across borders.

High-tech M&As were sometimes controversial

The wave of M&As led to a certain amount of controversy at the time. The sale of "national champions" in the knowledge-based industries to foreign competitors triggered public concerns in some countries – and was discouraged by policy makers in some others. However, standard arguments such as "losing our competitive advantages" and "being swallowed by the foreign competition" seem to presuppose that a main purpose of takeovers is the transfer of competences out of the host economy, and that there are such economics of scale that this will lead to irreparable economic losses. This could be the case in some parts of the knowledge-based economy, but there is little evidence to suggest that it applies generally – nor indeed that it is an issue of greater concern than in the traditional industries. Furthermore, the takeover of high-tech companies was often part of a process of corporate restructuring by which corporate entities sold certain subsidiaries in order to acquire others. In consequence, the economies that saw the largest inward investment are often the same ones from which the largest outward transactions originate (but this is not always the case – see below).

Some observers had the impression that the boom in FDI was largely technology-driven

A second observation that was much discussed in the public and press during the late 1990s was that the upsurge in cross-border direct investment

coincided with the strong M&A activity in the high-tech sectors. This made some commentators conclude that, for this reason, the growth in FDI was largely triggered by the high-tech boom. However, while there is some empirical support for this argument, the reality appears to have been more complex (see below).

Statistical evidence of cross-border M&As in high-tech sectors is surveyed in the following subsections. Two sectors are included. First, the high-tech industries, following standard OECD definitions, include aerospace, computers and office machinery, electronics and communications equipment, and pharmaceuticals. Second, the "new economy" service sectors include telecommunication and broadcasting, and information and data processing services. Given the nature of the high-tech sectors cross-border M&As are usually a reliable indicator of total FDI, but it should be noted that, as mentioned earlier, the available M&A data are not collected in accordance with OECD standards for direct investment statistics. Hence, direct comparisons between the M&A transactions and the official FDI statistics of Section I should be avoided.

3.1. The high-tech industries followed the general trend

Investment into the high-tech industries grew in the late 1990s, but not by more than overall flows

Cross-border mergers and acquisitions into and out of high-tech industrial companies domiciled in OECD countries more than trebled over the second half of 1990s, reaching an all-time record level in 1999 (Figure 3, Panel A). In this sense, it is probably correct to say that the mini-boom in FDI in the late 1990s involved significant amounts of investment by the high-tech industries. However, there is not much evidence that cross-border investment in this sector has grown (or, following 2000, declined) faster than FDI overall. On the contrary, the share of the high-tech industries in total OECD cross-border M&A has remained consistently around 9 per cent in the case of outflows, and 7 per cent in the case of inflows (Figure 3, Panel B).

United States was the main recipient

The geographic distribution of inflows to and outflows from the high-tech industries is highly uneven. Between 1995 and 2002, the United States was by far the greatest recipient of cross-border M&A within this sector, accounting for almost a third of total OECD area inflows (Figure 4, Panel A). With 17 per cent of total inflows during this period, Germany came second, with Sweden[4] in third position and France in fourth.

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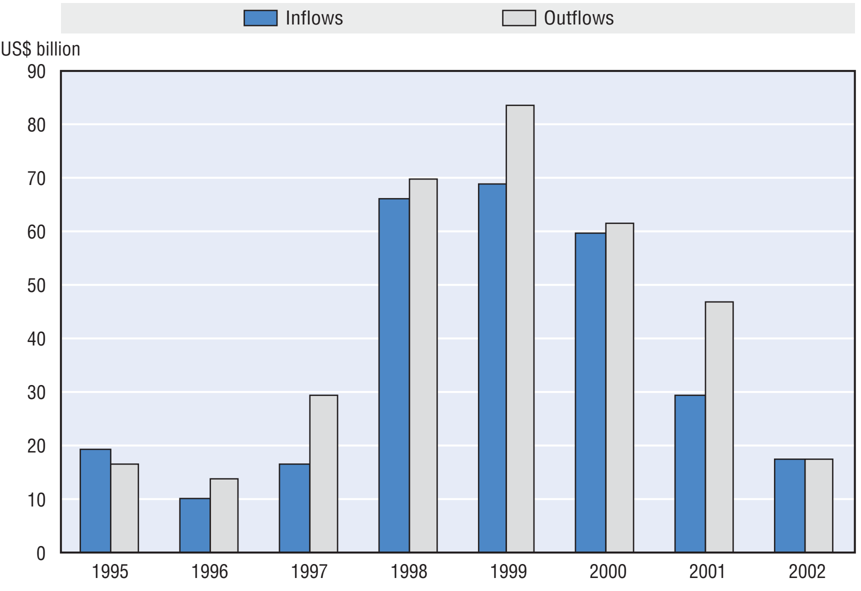
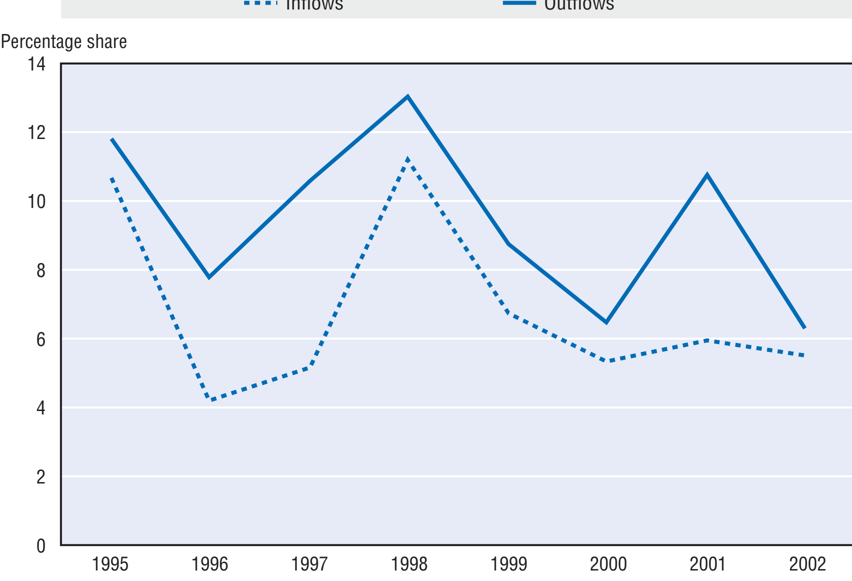
Figure 3. **Cross-border M&As in high-tech industries**

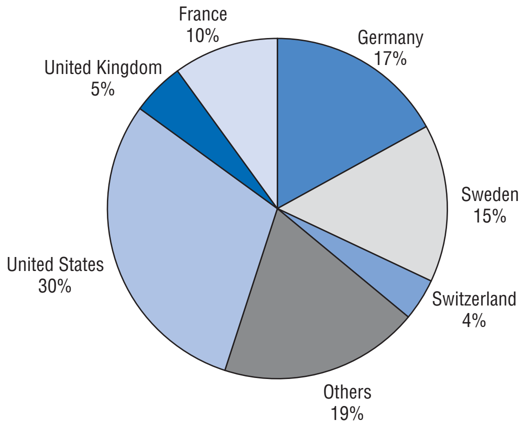




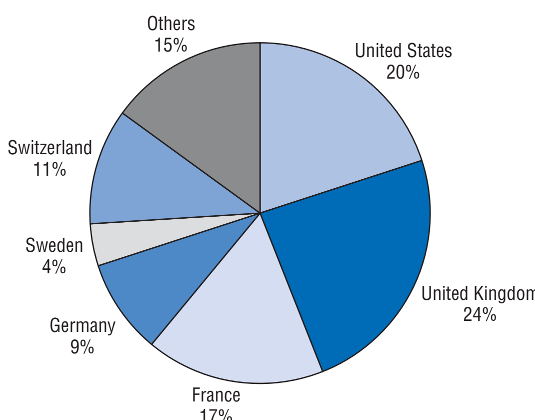
Source: Dealogic.

Figure 4. **OECD high-tech cross-border M&As, 1995-2002**

Panel A. Total inflows by country



Panel B. Total outflows by country



Source: Dealogic.

European countries were important providers of funds

The relative importance of investor countries was somewhat different. As an originator of high-tech industry M&A, the United States was relegated to second rank by the United Kingdom (Figure 4, Panel B) – a country which itself attracted little inward M&A to its high-tech industries. France was likewise more important as an outward investor than as a recipient, and with 11 per cent of total outflows Switzerland came in fourth place. In other words, some

countries (*e.g.* United States, France and Germany) appear to have taken part in cross-border structural restructuring within the high-tech industry itself in the sense that they received as well as contributed large amounts of international investment. Others (*e.g.* United Kingdom, Switzerland) witnessed large scale investment toward high-tech industrial companies abroad by domestic investors that were themselves not always classified as belonging to the high-tech industries.

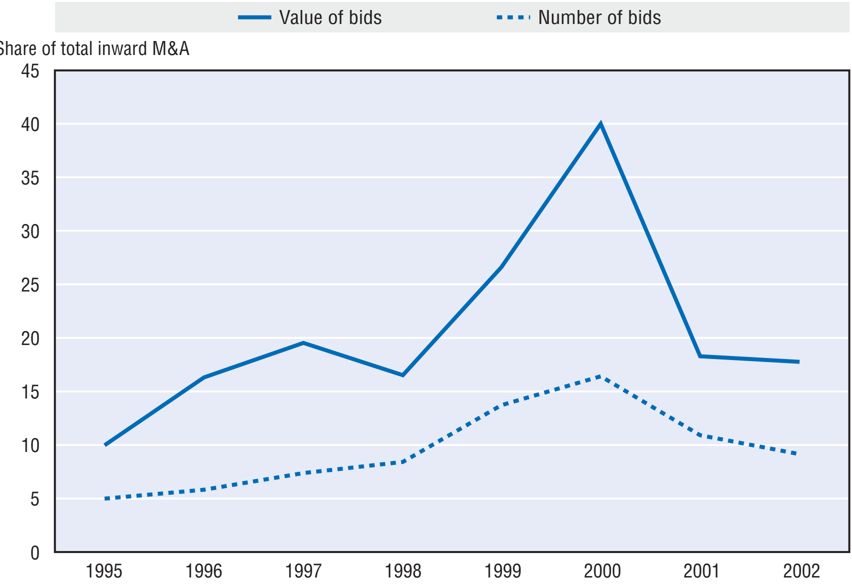
3.2. Strong investment in the "new economy" service sectors

Cross-border M&As into the "new economy" service sectors grew explosively in the 1990s

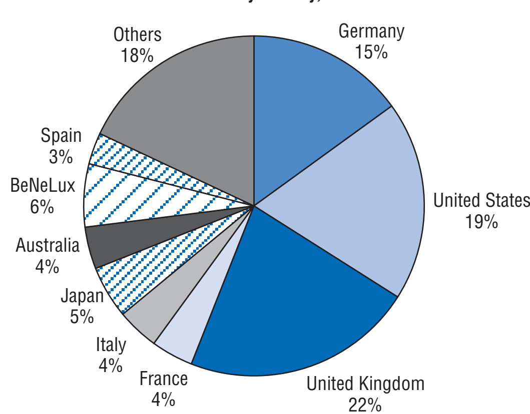
Cross-border M&As in the segments of the service sector that are commonly referred to as the "new economy" developed much more strongly in the late 1990s than those of the high-tech industry. Moreover, they peaked one year later in 2000. Cross-border inflows to the "new economy" sectors of all OECD countries are estimated to have climbed from a relatively puny USD 18 billion in 1995 to more than USD 400 billion in 2000. They have since fallen by more than 80 per cent.

These gyrations were far stronger than the changes in total FDI over the same period. The spike in "new economy" international investment in 1999 and 2000 appears to have reflected valuation as well as volume effects. The sector's share of total cross-border M&A into OECD countries, measured by the value of bids, rose from 10 per cent in 1995 to 40 per cent in 2000 (Figure 5, Panel A). At the same time, the share measured by the number of bids rose from 5 per cent to 15 per cent. This indicates that if the number of transactions rose relative to the remainder of the economy, so did the average value of each individual transaction.

Figure 5. **Cross-border M&As into "new economy" service sectors**



Panel B. Inflows by country, 1995-2002



Source: Dealogic.

A large group of countries was affected, not least within the EU area

Cross-border M&A into and out of the "new economy" is more evenly distributed across OECD countries than is the case with the high-tech industries, probably because cross-border M&A in services is not concentrated around a few market leaders to the same degree as in the high-tech industries. Also, the relative importance of countries as outward investors and recipients of investment is much more similar in the case of services.

The largest recipient of inward investment, as measured by cross-border M&A, between 1995 and 2002 was the United Kingdom with 22 per cent of total OECD inflows (Figure 5, Panel B). The United States came second with 19 per cent and German took third place with 15 per cent. The remainder was spread across a large number of OECD countries. At first glance it may appear surprising that several European countries took such a high share of "new economy" inflows. However, it should be noted that, according to scoreboards developed by a recent OECD study, the large European economies apply a more liberal approach to cross-border takeovers into these sectors than almost any other OECD members.[5] Moreover, cross-border investment into many of the European countries was encouraged by the privatisation of national telecom operators during the period under review.

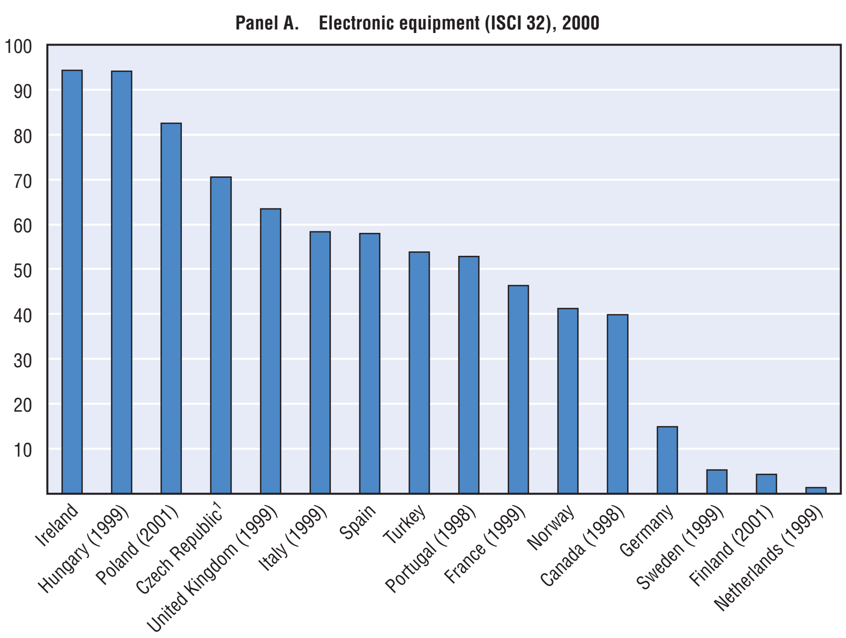
3.3. Economic activity in foreign-owned high-tech companies: a snapshot

Foreign affiliates dominate economic activity in the high-tech industries in many countries

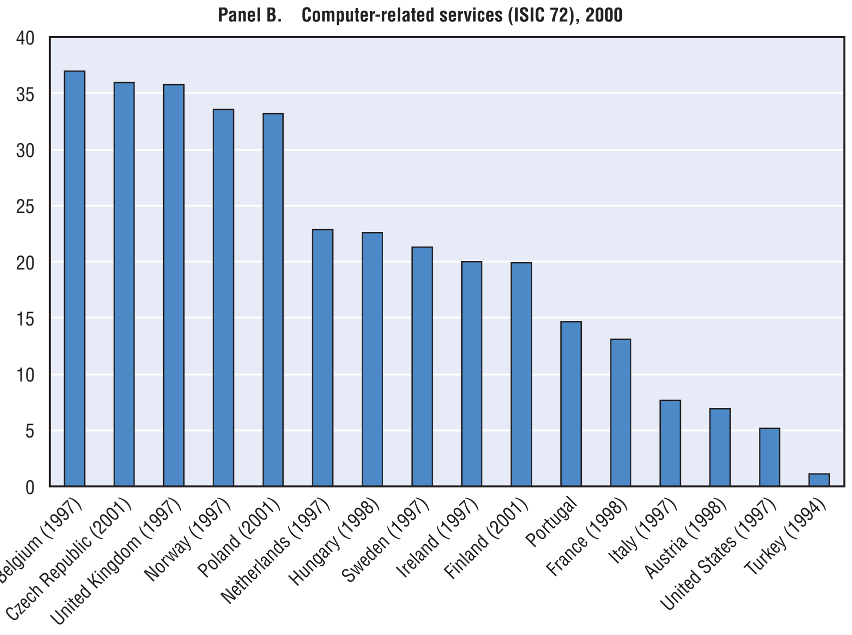
OECD wide or high-tech sector wide data for economic activity in the high-tech sectors are not available, but data for turnover in foreign affiliates in selected countries and sub-sectors may nevertheless shed valuable light on the importance of foreign presence for the home economy as a whole. As regards the technology intensive industries, manufacturing of electronic equipment is chosen as an illustrative example (Figure 6, Panel A). It appears that in countries with internationally important "national champions" in this sector (*e.g.* Netherlands, Finland, Sweden and Germany), foreign owned enterprises have been unable to secure significant market shares. On the other hand, in countries where these industries were until recently either uncompetitive or missing altogether (*e.g.* Ireland, Hungary, Poland and Czech Republic) most of the main players are foreign-owned enterprises that will have entered the markets through some form of FDI. Ireland and Hungary top the list with affiliates of foreign enterprises accounting for more then 90 per cent of the turnover in the electronic equipment industry.

Figure 6. **Share of turnover of foreign affiliates**

Panel A. Electronic equipment (ISCI 32), 2000



Panel B. Computer-related services (ISIC 72), 2000



Source: OECD Indicators of Economic Globalisation (forthcoming).

In the "new economy" service sectors there is less foreign dominance

In the high-tech service sectors, where economies of scale are presumed to be less important, and where much younger enterprises predominate, the concentration of economic activity is lower than in the industries. Also, the differences between countries appear to depend less on the level of economic development. Taking computer-related services as an example, the countries where foreign-owned companies have the largest market penetration are Belgium, the Czech Republic and the United Kingdom, in all of which countries the foreign-owned share of total turnover exceeds 35 per cent (Figure 6, Panel B). At the low end, it is entirely understandable that a market leader such as the United States should have a particularly low market penetration by foreign companies, but the low foreign presence in certain of the other countries is not easily explained. These are, however, mostly economies that (according to unrelated surveys) have been relatively slow in the uptake of computerised services such as the Internet. One of the reasons could therefore be that they have simply appeared less attractive to would-be entrants.

Notes

1. The Luxembourg figures are influenced by corporate restructuring under the aegis of holding companies located in this country. They must be interpreted with considerable caution.
2. The other components are "greenfield" investment in new plants, reinvested earnings and capital transfers between related enterprises.
3. The methodological differences were highlighted in the previous volume of this publication (*OECD International Investment Perspectives*, 2002, Vol. 1).
4. The inflows into Sweden and the outflows from Switzerland are, however, boosted by changes in ownership structure within a couple of large high-tech multinational enterprises operating in both countries.
5. Giuseppe Nicoletti, Steve Golub, Dana Hajkova, Daniel Mirza and Kwang-Yeol Yoo (2003), "Policies and International Integration: Influences on Trade and Foreign Direct Investment", Working Paper from the Economics Department, OECD, forthcoming.

ANNEX 1

International Direct Investment Statistics

Table A.1. **OECD direct investment abroad: outflows**

Million US dollars

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001p	2002e
Australia	992.3	1 199.4	5 266.9	1 947.0	2 816.5	3 281.8	7 087.6	6 427.9	3 344.8	687.9	557.8	10 992.2	6 816.9
Austria	1 627.2	1 285.3	1 697.5	1 190.5	1 257.2	1 130.6	1 935.0	1 988.2	2 745.2	3 300.7	5 740.9	3 492.3	5 402.2
Belgium/Luxembourg	5 956.0	6 066.2	10 955.9	3 850.5	1 205.4	11 728.4	7811.3	7 884.5	29 107.8	132 325.8	218 364.4	100 624.7	. .
Belgium	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	13 299.7
Canada	5 235.2	5 832.3	3 589.2	5 699.9	9 293.5	11 462.3	13 094.3	23 059.2	34 349.2	15 605.5	47 501.9	35 471.5	27 937.6
Czech Republic	. .	. .	. .	90.2	119.6	36.6	152.9	25.2	127.0	89.8	42.8	165.4	209.0
Denmark	1 618.2	2 051.8	2 236.0	1 260.5	3 955.1	3 063.5	2 519.1	4 377.3	4 476.4	16 924.5	25 032.9	12 966.7	4 850.4
Finland	2 708.5	–124.0	–751.7	1 407.1	4 297.8	1 497.3	3 596.5	5291.7	18 641.5	6 615.5	24 034.7	8372.0	9 798.4
France	36 228.4	25 137.6	30 407.1	19 736.1	24 372.3	15 758.1	30 419.5	35 580.9	48 612.7	126 859.2	177 481.6	92 991.1	62 602.7
Germany	24 231.9	22 947.0	18 595.1	17 196.1	18 857.8	39 051.6	50 806.3	41 794.1	88 837.2	109 648.4	56 856.8	42 086.3	24 557.3
Greece	. .	. .	. .	. .	. .	. .	. .	. .	–283.9	551.9	2 136.9	616.7	655.6
Hungary	. .	. .	. .	10.6	48.3	46.0	–1.6	454.7	500.8	271.2	578.4	343.0	259.5
Iceland	11.5	28.6	6.3	14.3	23.7	24.8	63.4	56.0	74.1	123.1	392.6	341.8	177.7
Ireland	364.7	192.6	214.4	217.8	436.3	819.8	727.9	1 013.7	3 902.1	6 109.1	4 629.6	5 865.0	2 708.2
Italy	7 611.7	7 325.9	5 948.5	7 230.6	5 108.8	5731.4	6 464.9	12 244.7	16 077.6	6 721.7	12 318.5	21 475.9	17 138.3
Japan	50 773.5	31 687.7	17 304.8	13 914.4	18 116.0	22 632.1	23 414.8	25 991.7	24 157.7	22 750.0	31 540.4	38 352.0	32 319.4
Korea	1 052.0	1 489.0	1 162.0	1 340.0	2 461.0	3 552.0	4 670.0	4 449.0	4 740.0	4 198.0	4 999.0	2 420.0	2674.0
Luxembourg	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	154 140.9
Mexico	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	4 404.0	969.0
Netherlands	13 664.2	12 823.6	12 694.6	10 062.1	17 559.8	20 193.4	32 112.5	24 489.3	36 478.5	57 626.7	73 539.7	48 514.1	26 269.8
New Zealand	2 360.7	1 472.4	391.4	–1 388.7	2 008.2	1 783.5	–1 239.7	–1 565.5	401.4	1 072.5	608.7	668.8	334.2
Norway	1 431.5	1 823.6	394.2	933.0	2 172.5	2 856.2	5 892.5	5 015.3	3 200.7	6 303.8	8 278.2	–735.8	4 830.7
Poland	. .	. .	13.0	18.0	29.0	42.0	53.0	45.0	316.0	31.3	17.2	–89.0	328.0
Portugal	164.8	473.6	6 84.2	107.3	282.5	684.6	785.4	1 926.2	3 845.9	3168.4	7513.8	7565.6	3 509.7
Slovak Republic	. .	. .	. .	12.8	17.7	41.8	58.8	94.3	138.4	–396.5	23.2	71.3	8.2
Spain	3 441.7	4 424.4	2 171.0	3 174.9	4 109.9	4 158.1	5 592.1	12 547.3	18 938.8	42 085.0	54 684.6	33 099.4	18 472.1
Sweden	14 748.2	7 057.6	408.7	1 357.7	6 701.1	11 214.3	5 024.8	12 647.5	24 379.4	21 929.0	40 597.8	6 587.8	10 886.5
Switzerland	7 176.9	6 542.5	6 058.5	8 765.4	10 798.0	12 213.9	16 150.8	17 747.9	18 768.8	33 264.3	44 698.1	17 307.1	11 801.1
Turkey	–16.0	27.0	65.0	14.0	49.0	113.0	110.0	251.0	367.0	645.0	870.0	497.0	175.0
United Kingdom	19 424.5	16 426.2	19 752.5	27 312.3	34 737.5	45 288.0	34 781.5	62 651.9	121 489.4	202 277.9	255 152.9	68 075.8	39 739.0
United States	37 183.0	37 889.0	48 266.0	83 950.0	80 167.0	98 750.0	91 885.0	104 803.0	142 644.0	188 901.0	178 294.0	127 840.0	123 528.0
Total OECD	**237 990.8**	**194 079.3**	**187 531.3**	**209 424.4**	**251 001.7**	**317 154.8**	**343 968.5**	**411 292.2**	**650 378.5**	**1 009 690.6**	**1 276 487.1**	**690 382.6**	**606 399.0**

Source: OECD International direct investment database, unless otherwise indicated.

Table A.2. **OECD direct investment from abroad: inflows**

Million US dollars

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001p	2002e
Australia	8115.8	4 302.1	5 719.8	4 281.7	5 024.6	11 963.2	6 111.0	7 633.4	6 002.6	2 923.9	13 007.0	3 997.7	13 959.2
Austria	650.9	351.3	1 432.7	1 136.5	2 102.9	1 904.2	4 428.6	2 655.6	4 534.1	2 974.6	8 841.7	6 053.9	1 651.3
Belgium/Luxembourg	7 516.0	8 919.4	10 957.3	10 467.8	8 313.2	10 894.2	13 924.4	16 510.1	30 146.9	142 512.3	22 0987.8	84 717.6	. .
Belgium	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	18 268.7
Canada	7 580.3	2 880.0	4 721.6	4 730.3	8 204.1	9 255.4	9 632.6	11 522.0	22 802.8	24 440.3	66 621.8	27 465.1	21 403.8
Czech Republic	. .	. .	. .	653.4	868.3	2 561.9	1 428.2	1 301.1	3 716.4	6 326.2	4 980.2	5 644.6	8 436.0
Denmark	1 206.7	1 459.9	1 014.7	1 669.0	4 897.6	4 179.8	768.0	2 798.9	7 725.7	16 691.8	32 754.6	11 485.0	5 967.2
Finland	787.5	–246.6	406.2	864.4	1 577.7	1 062.9	1 109.0	2 115.8	12 140.7	4 610.2	8 835.6	3 732.2	9 155.0
France	15 612.6	15 170.9	17 849.2	16 442.7	15 574.0	23 679.1	21 959.5	23 171.5	30 984.5	46 545.9	43 258.4	52 632.0	48 153.7
Germany	2 962.0	4 729.3	–2 088.9	368.3	7 133.9	12 025.4	6 572.8	12 243.4	24 596.7	55 796.9	203 117.4	33 923.7	38 069.0
Greece	1 688.4	1 718.1	1 588.6	1 243.6	1 166.1	1 197.7	1 196.4	1 088.6	73.9	561.5	1 108.6	1 589.5	49.9
Hungary	312.1	1 474.4	1 477.2	2 446.2	1 143.5	5 174.3	2 375.5	2 243.1	2 084.5	2 039.7	1 691.9	2 597.1	855.2
Iceland	22.0	18.2	–12.7	0.4	–1.5	9.2	83.1	147.9	147.8	66.6	170.5	192.6	149.4
Ireland	622.6	1 360.8	1 458.1	1 068.5	856.2	1 441.5	2 615.7	2 709.6	8 856.5	18 501.0	26 452.3	15 684.2	19 049.5
Italy	6 343.4	2 481.5	3 210.8	3 751.4	2 235.6	4 816.2	3 534.9	4 962.5	4 279.8	6 911.4	1 3377.3	14 873.4	14 558.2
Japan	1 809.4	1 286.2	2 755.2	206.9	890.1	42.5	229.7	3 223.1	3 193.5	12 740.4	8 318.6	6 247.9	9 253.5
Korea	789.0	1 180.0	728.0	588.0	809.0	1 776.0	2 325.0	2 844.0	5 412.0	9 333.0	9 283.0	3 528.0	1 972.0
Luxembourg	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	125 704.6
Mexico	2 633.0	4 761.0	4 393.0	4 389.0	10 973.0	9 647.0	9 943.0	14 160.0	12 170.0	12 856.0	15 484.0	25 334.0	13 627.0
Netherlands	10 517.4	5 775.3	6 165.6	6 443.1	7 145.0	12 286.2	16 650.9	11 103.8	36 933.8	41 186.3	60 313.2	51 244.3	29 181.7
New Zealand	1 683.1	1 695.6	1 089.2	2 211.6	2 615.7	2 849.7	3 922.0	1 917.2	1 825.5	940.4	1 344.4	3 957.7	296.8
Norway	1 176.7	–48.9	810.4	1 460.7	2 777.6	2 408.0	3 168.5	3 946.4	4 353.7	8 297.0	5 890.2	2 067.1	761.5
Poland	88.0	359.0	678.0	1 715.0	1 875.0	3 659.0	4 498.0	4 908.2	6 364.9	7 269.6	9 342.3	5 713.0	4 082.0
Portugal	2 255.4	2 291.6	1 903.8	1 516.2	1 254.6	660.1	1 488.5	2 478.8	3 143.5	1 233.5	6 788.6	5 893.7	4 260.0
Slovak Republic	. .	. .	. .	179.1	272.9	229.6	369.7	214.8	527.4	403.5	2 153.6	1 271.0	4 009.3
Spain	13 838.6	12 445.2	13 350.7	9 573.1	9 275.6	6 283.9	6 820.1	6 386.7	11 800.1	15 758.6	37 530.2	28 010.4	21 212.3
Sweden	1 971.4	6 355.8	41.0	3 845.1	6 349.7	14 446.9	5 436.6	10 967.4	19 842.7	60 856.2	23 242.1	11 770.2	11 099.4
Switzerland	5 484.9	2 642.8	411.2	–83.3	3 368.4	2 223.2	3 078.2	6 641.8	8 941.9	11 714.0	19 266.0	8 867.2	9 314.0
Turkey	684.0	810.0	844.0	636.0	608.0	885.0	722.0	805.0	940.0	783.0	982.0	3 266.0	1 037.0
United Kingdom	33 982.2	16 223.3	16 528.0	16 430.9	10 866.4	21 825.8	27 406.4	37 384.1	74 642.1	89 288.1	119 741.1	61 993.4	24 967.0
United States	48 494.0	23 171.0	19 823.0	51 362.0	46 121.0	57 776.0	86 502.0	105 603.0	179 045.0	289 454.0	307 747.0	130 796.0	30 114.0
Total OECD	**178 827.6**	**123 567.3**	**117 255.6**	**149 597.7**	**164 298.3**	**227 164.1**	**248 300.4**	**303 687.7**	**527 229.0**	**893 015.8**	**1 272 631.3**	**614 548.5**	**490 618.0**

Source: OECD International direct investment database, unless otherwise indicated.

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Table A.3. **OECD direct investment abroad: outward position**

Million US dollars

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001p	2002e
Australia	30 494.9	30 897.0	34 559.6	40 503.6	47 786.3	53 009.0	6 6857.9	71 968.4	78 647.9	89 587.5	83 231.9	91 414.3	91 217.1
Austria	4 746.9	5 993.6	6 584.5	7 974.2	9 514.1	11 832.0	13 059.8	14 011.4	17 468.4	19 127.3	24 819.9	26 967.5	38 066.3
Belgium	..	..	..	..	..	..	..	..	..	..	..	..	..
Canada	8 4812.7	94 387.4	87 867.3	92 469.1	104 308.0	118 106.1	132 321.9	152 959.3	171 784.7	201 446.8	235 409.8	244 667.5	273 384.6
Czech Republic	..	..	..	181.4	300.4	345.5	498.0	548.2	804.1	697.9	737.9	1 135.6	1 495.6
Denmark	..	15 612.0	16 305.7	15 799.2	19 613.7	24 702.5	27 601.6	28 127.7	34 859.2	44 854.6	65 899.5	69 753.2	..
Finland	11 227.3	10 845.3	8 564.6	9 178.2	12 534.0	14 993.2	17 666.0	20 297.5	29 405.9	33 850.3	52 108.7	52 226.1	69 466.2
France	110 120.6	129 900.5	156 326.6	158 750.3	182 331.8	204 430.3	231 112.8	237 248.9	288 035.9	334 102.9	445 087.0	489 436.9	652 079.5
Germany	130 760.3	150 517.4	154 741.3	162 365.0	194 523.4	233 107.4	248 634.1	296 274.9	365 195.7	411 943.9	478 316.7	505 308.0	..
Greece	..	..	..	..	..	..	..	..	2 792.2	3 217.9	5 851.7	6 511.9	..
Hungary	..	..	223.6	224.6	291.2	493.7	497.2	897.2	1 302.3	1 524.1	1 974.5	2 257.5	2 744.1
Iceland	75.2	101.1	98.1	113.5	148.5	177.2	240.1	275.0	360.5	451.8	662.9	840.2	1 079.2
Ireland	..	..	..	..	..	..	..	..	20 314.4	25 232.1	27 925.0	33 747.2	..
Italy	60 195.3	70 419.3	70 382.3	81 086.6	89 688.3	106 318.6	117 278.0	139 437.2	176 985.2	181 855.5	180 273.6	182 373.3	194 490.4
Japan	201 440.0	231 790.0	248 060.0	259 800.0	275 570.0	238 452.0	258 608.9	271 905.7	270 037.5	248 778.0	278 444.1	300 116.4	304 234.1
Korea	..	..	..	..	..	..	..	..	..	..	..	19 967.0	..
Luxembourg	..	..	..	..	..	4 703.4	4 695.4	5 022.4	7 995.8	8 134.6	..	..	..
Mexico	..	..	..	..	..	..	..	..	..	..	..	..	11 944.0
Netherlands	108 352.8	120 095.1	123 032.8	127 284.7	150 522.5	178 464.3	203 237.7	209 577.4	230 769.3	263 755.7	307 760.4	329 382,5	..
New Zealand	..	..	5 899.0	4 430.7	5 896.2	7 675.6	9 293.1	5 646.0	5 490.8	7 006.2	6 065.1	6 971.3	8 470.9
Norway	10 889.2	12 149.1	11 794.4	12 717.7	17 648.0	22 520.7	25 439.1	27 494.5	31 578.2	31 871.3	33 651.4	0.0	..
Poland	..	..	101.0	198.0	461.0	539.0	735.0	678.0	1 165.0	1 024.1	1 018.0	11 07.0	..
Portugal	..	..	..	..	..	4 406.3	3 953.9	5 414.0	9 622.4	10 330.8	17 169.7	23 490.5	319 81.5
Slovak Republic	..	..	..	..	141.8	111.1	160.4	214.7	379.0	302.9	325.2	399.5	423.3
Spain	..	..	22 034.4	24 017.8	30 049.5	36 241.6	40 556.3	50 309.2	70 125.9	112 780.1	164 788.8	189 416.1	216 042.3
Sweden	50 719.5	54 797.6	48 844.6	45 522.5	60 309.0	73 142.5	72 187.8	78 201.2	93 533.7	106 273.8	123 234.0	122 049.5	145 376.7
Switzerland	66 086.9	75 880.8	74 412.2	91 570.3	112 588.0	142 481.4	141 586.8	165 354.1	184 237.1	194 598.5	233 385.2	247 808.1	..
Turkey	..	..	..	..	..	..	..	..	..	..	3 668.0	3 775.0	..
United Kingdom	229 306.7	232 140.8	221 678.9	245 628.9	276 743.8	304 864.9	330 432.5	360 796.3	488 372.0	686 420.4	897 844.8	899 161.0	1 032 962.3
United States	731 762.0	827 537.0	798 630.0	1 061 299.0	1 114 582.0	1 363 792.0	1 608 340.0	1 879 285.0	2 279 601.0	2 839 639.0	2 694 014.0	2 301 913.0	
Total OECD	**1 830 990.2**	**2 063 063.8**	**2 090 140.8**	**2 441 115.2**	**2 705 551.6**	**3 144 910.1**	**3 554 994.4**	**4 021 944.3**	**4 860 864.2**	**5 858 808.1**	**6 363 667.6**	**5 822 813.6**	..

Note: Source is IMF for : Japan 1990-95, Denmark 1992, 1993, 1995 and 1997.

Source: OECD International direct investment database, unless otherwise indicated.

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Table A.4. **OECD direct investment from abroad: inward position**

Million US dollars

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001p	2002e
Australia	73 615.1	77 077.7	75 821.7	82 877.7	95 543.8	104 074.3	116 797.2	101 089.0	105 961.7	121 661.0	109 262.7	1054 74.0	128 650.7
Austria	10 971.8	11 510.1	12 040.8	12 105.5	14 636.0	1 9721.0	19 629.2	19 522.2	23 564.8	23 471.6	30 430.8	348 11.0	43 309.6
Belgium	..	..	..	..	..	..	..	..	..	..	..	..	..
Canada	11 2850.3	117 031.5	108 500.1	106 869.7	110 210.1	123 182.3	132 970.2	135 935.6	143 348.8	175 000.9	205 040.2	2094 89.4	221 197.5
Czech Republic	..	..	..	3 422.8	4 546.6	7 349.8	8 573.1	9 233.2	14 377.1	17 549.5	21 647.0	27 092.8	38 453.1
Denmark	..	14 747.0	14 387.3	14 617.9	17 846.3	23 800.9	22 337.0	22 267.8	31 179.1	41 270.5	66 469.2	65 819.5	..
Finland	5 132.4	4 220.5	3 688.9	4 216.7	6 714.1	8 464.5	8 797.5	9 529.8	16 454.8	18320.4	24 272.3	24 069.8	35 507.6
France	84 930.9	97 450.5	127 881.4	135 077.8	163 451.4	191 433.0	200 095.8	195 913.0	246 215.9	24 4672.5	259 773.0	289 012.1	401 288.8
Germany	74 066.8	77 927.8	74 730.1	71 095.4	85 904.8	102 491.2	102 652.9	18 8874.3	250 319.9	288 562.4	439 559.9	453 025.5	..
Greece	..	..	..	..	..	..	..	..	13 088.1	15 533.3	1 2479.4	13 466.1	..
Hungary	568.8	2106.7	3 424.1	5 575.6	7 083.5	12 958.5	15 167.4	16 312.0	18 829.6	19 541.5	19 997.2	23 074.0	28 708.9
Iceland	147.1	165.6	123.8	116.5	127.5	148.7	197.4	331.9	457.0	571.9	842.8	713.9	..
Ireland	..	..	..	..	..	..	..	..	62 453.1	72 817.0	118 549.4	138 264.7	..
Italy	60 008.5	61 592.3	49 972.7	53 961.9	60 416.0	65 347.2	74 599.9	85 401.8	108 835.3	108 640.7	113 046.4	107 920.2	126 475.5
Japan	9 850.0	12 290.0	15 510.0	16 890.0	19 170.0	33 507.7	29 937.1	27 077.5	26 064.8	46 115.3	50 322.8	50 319.7	78 142.8
Korea	..	..	..	..	..	..	..	..	..	..	..	..	..
Luxembourg	..	..	..	..	..	18 503.5	18 232.8	17 279.6	20 766.1	20 362.0	23 145.4	..	..
Mexico	22 424.4	30 790.0	35 680.0	40 600.4	33 197.7	41 129.6	46 912.0	55 810.0	63 610.4	78 060.0	97 170.2	140 376.0	..
Netherlands	73 334.4	78 858.7	81 270.8	83 179.2	103 981.3	121 972.4	131 139.2	127 424.3	168 867.5	192 587.9	246 643.2	285 387.2	..
New Zealand	..	..	11 779.5	15 539.1	22 062.2	25 727.6	34 743.7	31 365.3	33 169.9	32 860.8	28 069.8	20 642.5	25 425.7
Norway	12 403.8	15 865.2	13 644.9	13 642.5	17 018.0	19 835.9	20 623.8	20 704.4	26 081.4	29 433.0	30 261.4	32 589.6	..
Poland	109.0	425.0	1 370.0	2 307.0	3 789.0	7 843.0	11 463.4	14 587.2	22 479.0	26 075.3	34 227.0	41 031.0	..
Portugal	..	..	..	..	..	18 162.1	19 861.1	19 305.9	24 465.6	23 519.2	28 468.8	32 920.5	43 960.7
Slovak Republic	..	..	..	..	777.9	1 161.5	1 446.7	1 670.6	2 128.4	2 272.3	3 737.7	4 774.8	7 474.7
Spain	..	..	85 979.5	80 267.9	96 300.9	109 276.4	107 976.9	100 040.3	118 154.1	116 336.5	144 801.7	164 752.8	217 759.7
Sweden	12 636.0	18 085.0	14 057.0	13 126.9	22 649.4	31 089.3	34 784.1	41 512.7	50 984.6	73 312.5	93 972.5	92 240.2	..
Switzerland	34 244.6	35 747.2	32 989.3	38 713.5	48 668.4	57 063.7	53 916.7	59 515.2	71 997.1	76 000.2	86 809.8	89 269.6	..
Turkey	..	..	..	..	..	..	..	..	..	..	19 209.0	17 521.0	..
United Kingdom	203 905.3	208 345.5	172 986.4	179 232.6	189 587.5	199 771.8	228 642.5	252 958.6	337 386.1	385 146.1	438 630.7	531 593.4	638 535.5
United States	505 346.0	533 404.0	540 270.0	593 313.0	617 982.0	680 066.0	745 619.0	824 136.0	920 044.0	1 101 709.0	1 418 523.0	1 514 374.0	1 504 428.0
Total OECD	**1 296 545.1**	**1 397 640.2**	**1 476 108.4**	**1 566 749.3**	**1 741 664.2**	**2 024 082.0**	**2 187 116.2**	**2 377 798.2**	**2 921 044.0**	**3 351 403.2**	**3 668 217.2**	**4 261 214.1**	**..**

Note: Source is IMF for : Japan 1990-95, Denmark 1992, 1993, 1995 and 1997.

Source: OECD International direct investment database, unless otherwise indicated.

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Chapter 2

China's Foreign Investment Policy Reform: from Incentives to Modern Rules*

China has made progress in providing a business conducive to foreign direct investment (FDI). The challenge now is to move towards a more rules-based policy framework that will attract high-quality FDI from OECD countries. The OECD proposes a number of policy options for the Chinese government to consider in further developing such a framework. These include additional streamlining of the investment project approval process, reconsideration of unnecessary sectoral restrictions on foreign investment, and measures to increase transparency and strengthen the rule of law.

This article is based on the recent publication China: Progress and Reform Challenges, *OECD Investment Policy Review, 2003.*

* This article was prepared by Kenneth Davies, Principal Administrator, Capital Movements, International Investment and Services Division, OECD.

China has succeeded in attracting large quantities of foreign direct investment (FDI) since the economy was opened up at the end of the 1970s. Nevertheless, challenges remain, in particular that of formulating policies to attract "high quality" investment, especially from OECD countries, which continue to provide the overwhelming majority of global FDI outflows. This article, which is based on a recently published study by the OECD,[1] examines the development of Chinese government policy with regard to FDI and offers policy options designed to produce a business environment directly relevant to the attraction of such investments from OECD countries. Certain policy changes bearing on the broader enabling environment for investment (*e.g.* rule of law, intellectual property rights and corruption) are listed in Annex I. A list of the abbreviations and acronyms employed throughout the article is provided in Annex II.

1. The record of FDI inflows to China[2]

1.1. Total FDI inflows are high, but per capita inflows are relatively low

Inflows of FDI into China rose from less than 600 million US dollars (USD) per year when they first began to arrive in the early 1980s to an estimated USD 52.7 billion in 2002. Hence, for the first time in history China became the world's largest recipient of FDI.

Already during the 1990s, China received more FDI than other developing countries (Table 1). At the height of the 1997-99 Asian economic crisis, when many of its neighbours were experiencing reduced capital inflows, China's realised FDI inflows held steady at over USD 45 billion in 1998, before falling to USD 40 billion in 1999 and 2000. They then rose sharply in 2001 to USD 46.9 billion, equivalent to 10.7 per cent of gross domestic fixed capital formation and 4.1 per cent of GDP.[3] This recovery was almost certainly due not so much to the return of investors who took fright during the Asian economic crisis of 1997-99, which had only a limited impact on China compared to the rest of Asia, as to the diversion of FDI from South-East Asia and other investment targets in anticipation of China's imminent accession to the World Trade Organisation (WTO).

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Table 1. **FDI inflows to China and selected developing countries, 1995-2001**
(USD million)

Country or territory	1995	1996	1997	1998	1999	2000	2001
China	35 849	40 180	44 237	43 751	38 753	40 710	46 880
Hong Kong (China)	–	–	–	14 776	24 587	61 883	22 834
Myanmar	277	310	387	314	253	255	n.a.
India	2 144	2 426	3 577	2 635	2 169	2 315	n.a.
Indonesia	4 346	6 194	4 677	–356	–2 745	–4 550	n.a.
Malaysia	4 178	5 078	5 137	2 163	3 895	3 788	n.a.
Philippines	1 478	1 517	1 222	2 287	573	1 241	1 792
Singapore	8 788	10 372	12 967	6 316	7 197	6 390	n.a.
Thailand	2 068	2 336	3 895	7 315	6 213	3 366	3 820
Vietnam	-	2 395	2 220	1 671	1 412	1 298	n.a.
South Africa	1 248	816	3 811	550	1 503	969	7 162
Argentina	5 609	6 948	9 160	7 291	23 988	11 657	3 214
Brazil	48 590	11 200	19 650	31 913	28 576	32 779	22 636
Chile	2 957	4 633	5 219	4 638	9 221	3 675	n.a.

Source: IMF, International Financial Statistics, October 2002; National Bureau of Statistics, *China Statistical Abstract [zhongguo tongji zhaiyao]*, 2002 (China figures for 2000 and 2001).

However, in terms of FDI inflows per capita China lagged behind most OECD countries. It was also surpassed in per capita terms by the larger South American economies and even by developing countries in South-East Asia such as Malaysia and Thailand. If economic and geographical characteristics are taken into account, China's performance compares quite modestly with that of other developing countries.[4]

1.2. OECD countries are under-represented among sources of China's FDI inflows

Although an increasing proportion of FDI flowing into China is sourced in OECD countries, the latter tend to be under-represented compared with sources such as Hong Kong (China), which has supplied nearly half of cumulative FDI inflows to China and continues to provide nearly 40 per cent of the annual inflow.[5] For instance, cumulative realised[6] FDI inflows to China from the United States up to end-2000 represented only 8.6 per cent of the total, compared to 48.9 per cent from Hong Kong; this is far lower than the share of the United States in global investment, as indicated by its 21.5 per cent of cumulative FDI outflows by OECD countries in 1992-2001,[7] and also lower than the United States' 15.7 per cent share of China's merchandise exports and imports.[8] Similarly, cumulative realised FDI inflows into China from Japan up to end-2000 accounted for only 8 per cent of the total, compared with Japan's 17.5 per cent share of China's two-way merchandise trade.

1.3. Regional distribution of FDI

The spatial distribution of realised FDI has been skewed towards the eastern coastal areas throughout the period of economic reform. The south-eastern province of Guangdong has received the lion's share of FDI, largely because it is adjacent to Hong Kong (China), the main provider of FDI and China's largest port, and also because it houses three of the Special Economic Zones (SEZs), Shenzhen, Zhuhai and Shantou, together with the prosperous Pearl River Delta open zone. By end-2000 Guangdong, whose population was only 6.8 per cent of the national total and which contributed only 11 per cent of GDP in that year, had absorbed 28.2 per cent of China's cumulative realised FDI. Within Guangdong, Shenzhen SEZ accounted for 4.5 per cent of cumulative national FDI, more than most provinces.[9]

Proximity to major investors was also the main determinant of high levels of FDI inflows in other coastal provinces. Fujian, which is located opposite Chinese Taipei across the Taiwan Strait, received 9.1 per cent of cumulative investment, of which just over one-third went to the Xiamen SEZ. Liaoning, which otherwise had limited attractiveness because of its concentration of state-owned heavy industry, benefited from Japanese investment in Dalian, a coastal city which had played a key role in trade with Japan during the Japanese occupation of North-East China. Cumulative FDI inflows into Dalian up to 2000 represented 2.5 per cent of the national total and over half of inflows to the whole of Liaoning. Shandong, near to Japan and South Korea, absorbed 6.1 per cent of total investment. The whole coastal region was also more attractive to foreign investors than were hinterland provinces because the government's encouragement of export-oriented FDI favoured locations possessing easy access to ports and shipping routes.

Another important determinant of high levels of FDI has been state expenditure on infrastructure, notably in the major province-level cities of Beijing, which received 4.1 per cent of cumulative FDI, Tianjin, which received 3.8 per cent, and Shanghai, which, although major construction work and FDI attraction only really took off in the 1990s, received 8.1 per cent of China's total realised inward FDI in the two decades up to 2000.

Guangdong and Fujian also benefited from revenue-sharing agreements with the central government which allowed them to keep a relatively large share of their tax revenue, which they were able to use to upgrade the inadequate or nonexistent (in places such as Shenzhen, which had been a mere border village) physical infrastructure. By contrast, Shanghai, which had been the centre of political upheavals in the 1960s, was not favoured in the early part of the reform period. Consequently, it was compelled to turn in a high proportion of its tax revenues to the central government. As a result,

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before the 1990s it lacked resources to restore its infrastructure, once the envy of Asia, which had become dilapidated over the previous four decades.

Inland provinces suffered a relative dearth of FDI because of the difficulty and high cost of transporting products to ports for export. As labour has become gradually more mobile, skilled labour has shifted from these areas to the more prosperous coastal zones, raising labour costs in the inland provinces, especially in high-technology projects. Whereas foreign-invested enterprises (FIEs) have increasingly been servicing the domestic market in the Eastern region rather than exporting all their products, consumer markets in the Central and Western regions remain relatively weak. Consequently, there has been a tendency for foreign investors to adopt a "wait and see" posture towards the hinterland, purchasing land leases for possible future use there while maintaining an eastward bias in the distribution of productive investments.

This regional imbalance is clear from a comparison of the three regional groupings currently used in the government's economic development strategy. The Eastern region, comprising Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan, accounted for 86.0 per cent of the cumulative inflows of realised FDI at the end of 2001 (Table 2). At the same time, the Central region, consisting of Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei and Hunan, received 8.8 per cent and the Western region, encompassing Inner Mongolia, Guangxi, Sichuan, Chongqing, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang and Tibet accounted for the remainder.

Table 2. **Cumulative FDI inflows to East, Central and West China as of 2001**

Region	Projects (Number)	Share (%)	Contractual value (USD million)	Share (%)	Realised value (USD million)	Share (%)
Total	**390 025**	**100.0**	**745 291**	**100.0**	**395 223**	**100.0**
East	315 053	80.8	643 923	86.4	339 726	86.0
Central	46 713	12.0	56 521	7.6	34 693	8.8
West	28 259	7.2	44 847	6.0	20 804	5.3

Source: MOFCOM FDI Statistics.

1.4. Motivation for FDI in China

Understanding the motivations of companies seeking to make direct investments is essential not only for an appreciation of the factors that have influenced the composition of FDI in China so far, but also in deciding the most appropriate way to attract the desired types of FDI in future.

Using the typology described in a recent OECD study of the benefits and costs of FDI for development,[10] a high proportion of FDI inflows into China, especially in the first decade and a half of the opening-up policy, consisted of resource-seeking investment. Industrial economies in which labour and land costs had risen to uncompetitive levels experienced a massive shift of manufacturing capacity to China to take advantage of low land lease charges and far lower wages. Chief among these was Hong Kong (China), which accounted for the largest share of FDI inflows, probably even after stripping out overcounting resulting from the funnelling of investment from overseas or from China itself. From 1989, a similar relocation of enterprises began to occur in Chinese Taipei, from where whole industries were transferred to the Chinese mainland.

Despite the much publicised lure of the vast Chinese market, market-seeking FDI was not common in the early stages of the opening-up process. Although China has a large population, the market for consumer goods has until recently been smaller than that of several South-East Asian countries because of low per capita disposable incomes.

The situation changed in the 1990s as disposable incomes rose high enough to allow discretionary spending. Urban households now possess a wide range of consumer durables, and this range is constantly widening. As purchasing power has increased, legal restrictions on consumption have been relaxed, allowing the development of entirely new markets, including family cars and tourism. Market-seeking investment is thus increasing in response to the burgeoning Chinese domestic market.

Other motivations are less in evidence. There is some natural-resource-seeking FDI, but this is very much subject to strict government controls. Unlike countries at an earlier stage of development, China has more to offer foreign investors than cheap energy or raw materials. Efficiency-seeking FDI, which involves outsourcing of whole products to the host country, does occur, but its potential will not be realised until China has reached a higher stage of technological development. Investors seeking strategic assets to acquire market power have, with a few notable exceptions, steered clear of China; those that have gained such power are likely to face strong challenges to it.

It is also important to note that many multinational corporations have invested in China for what may be judged less than rational motives, in particular the "herd" instinct, often expressed as a fear of being overtaken by rivals in the same industry who got there first. One argument in support of such a stance is that of the necessity of establishing an early presence in the China market to steal a march over latecomers. This has increasingly proved false, especially as the Chinese business environment has in recent years become more "normal", with customers and suppliers more concerned about quality and price than about establishing "*guanxi*" (connections), although *guanxi* still

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matter to some extent. The assumption underlying these attitudes is the old one of the potentially limitless China market, a concept which has paid its believers far less than they would have gained from localised market research.

2. The evolution of FDI policy in China

2.1. The refinement of the FDI policy framework in the 1990s

In the 1990s the previously patchy legal framework governing FDI was refined and expanded so that by the end of the decade a body of FDI law and regulations was in place. Experience gained in the 1980s enabled the authorities to expedite the process of examination and approval of foreign investment projects so that it became less arduous and time-consuming. In the 1980s manufacturing FIEs were encouraged to export and not attempt to serve the domestic market, not merely by export performance requirements but also by restrictions such as those on distribution of products and the provision of after-sales service within China. During this period, FDI was largely concentrated in the five SEZs in South-East China and most of the rest of the country was officially closed even to visitors. By the mid-1990s most of the coastal region consisted of various types of open zones operating preferential policies to attract FDI and China had for all practical purposes become a completely open country.

In the 1980s FDI was largely concentrated in joint venture labour-intensive export manufacturing. As a result of the more favourable climate for FDI, in the 1990s a growing proportion of FIEs were wholly-foreign-owned enterprises, oriented to the expanding domestic market as well as to overseas markets, and a number of large, relatively high-technology projects initiated by multinational enterprises from OECD countries began to appear.

2.2. One law for each type of FIE

China's laws relating directly to FDI take the form of separate legislative enactments for each form of FIE, together with some laws which apply to all FIEs. The advantage of such multiform legislation is that foreign investors can be certain of the rules governing the particular form of investment in China that they have chosen. The disadvantage is that this legislative division produces a compartmentalisation that makes it difficult to co-ordinate the activities of different enterprises. For instance, merging enterprises of different forms is made excessively complex. As a result of China's accession to the WTO, it has already been necessary to remove a number of requirements from these laws and it is likely that future relaxation of restrictions on foreign investment will necessitate further changes. Ultimately, the Chinese government has the option of integrating FDI law into

domestic company law so that FIEs are treated on a par with domestic enterprises.

In the initial phase, FDI inflows were limited to joint ventures between foreign companies and Chinese entities, usually state-owned enterprises (SOEs). This form suited both China and foreign investors. Starting from an economy in which all major enterprises were state-owned, it would have been difficult politically for the government to accept entirely foreign-owned private enterprises at the outset. Foreign investors needed Chinese partners to help them understand and deal with an unfamiliar and uncertain operating environment.

Joint ventures took two general forms: equity joint ventures and contractual (also translated as co-operative) joint ventures. In July 1979 the National People's Congress (NPC – China's parliament) adopted a law on Sino-foreign equity joint ventures. This was followed in 1988 by a law on Sino-foreign contractual joint ventures. This sequence was the reverse of the developments on the ground: contractual joint ventures predominated in the first half of the 1980s before equity joint ventures gained dominance. The law also permitted the signing of joint exploitation contracts between a foreign company and a Chinese entity for projects involving joint exploration for both inland and offshore oil and gas, or other mineral resources.

The law governing wholly-foreign-owned enterprises was passed in April 1986. In consequence, an increasing proportion of FIEs are enterprises in which there is no Chinese partner, *i.e.* wholly-foreign-owned enterprises. A wholly-foreign-owned enterprise is a limited liability company or other form of organisation established in China by foreign investors exclusively with their own capital. The term explicitly excludes branches of foreign companies in China. More recently, China has permitted the establishment of foreign-invested companies limited by shares and foreign-invested holding companies, as well as build-operate-transfer infrastructure projects.

2.3. Further liberalisation resulting from WTO accession in 2001

On 11 December 2001 China acceded to the WTO. Bilateral agreements signed with other WTO members as part of the accession process were weighted in favour of market-opening concessions by China.[11] Although the main focus of the agreements was on opening Chinese markets to imports by curtailing trade barriers, increased market access is also being accelerated by opening a number of sectors, service sectors in particular, far wider to foreign investment within periods generally varying up to five years from accession.

FDI in the financial sector is being greatly liberalised. Foreign banks will be allowed within five years after accession to conduct business in local or foreign currency anywhere in China. Foreign securities houses will be able to

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engage directly in B-share business and indirectly, via joint ventures, in A-share business. (B shares are denominated in foreign currency and are available to foreign holders; A shares are denominated in renminbi and are for domestic purchasers.) Geographical restrictions on foreign insurance companies will be lifted within three years of WTO accession and the range of insurance policies which they may provide is to be expanded.

Foreign majority ownership will be permitted in wholesaling and retailing joint ventures two years after accession and the range of products handled by such enterprises is to be expanded. Foreign majority ownership in distribution services will be allowed after two years and no geographic or quantitative restrictions will apply to the enterprises concerned. Market access and national treatment restrictions on franchising and wholesale or retail trade services away from a fixed location will be lifted after three years.

Business services will also be further opened to foreign investment. Geographic and quantitative restrictions on foreign law firms were lifted one year after accession, but restrictions remain on business scope. In particular, foreign law firms may not practise Chinese law. Foreign accounting firms may now establish wholly foreign-owned subsidiaries, affiliate with Chinese firms and enter into contracts with their affiliated firms in other WTO countries. Foreign firms providing tax services will be permitted to establish wholly-owned subsidiaries six years after accession. Wholly foreign-owned enterprises may provide architectural, engineering, and urban planning services five years after accession. Offshore oil-field services are permitted in the form of petroleum exploitation in co-operation with Chinese partners in specified locations. Wholly foreign-owned subsidiaries may provide advertising services four years after accession. Foreign service suppliers may provide translation and interpretation services through joint ventures, with foreign majority ownership permitted. Foreign service suppliers will be permitted to establish wholly-owned subsidiaries four years after accession.

More restricted opening to foreign investment is to be allowed in high-technology and communications services sectors. Only joint ventures are allowed in software and data-processing services, but foreign majority ownership is permitted. Geographical restrictions on telecommunications joint ventures will be abolished two years after accession and the maximum foreign equity stake will be raised to 50 per cent. Foreign suppliers are permitted to establish contractual joint ventures with Chinese partners to engage in the distribution of audiovisual products, excluding motion pictures.

In consumer services, wholly foreign-owned subsidiaries will be permitted in the travel agency and tour operator sector four years after accession. Wholly foreign-owned subsidiaries may construct, renovate and operate hotels and restaurants establishments four years after accession. Joint

venture hospitals or clinics may be set up with Chinese partners (with foreign majority ownership permitted), subject to quantitative limitations in line with China's needs as evaluated by the authorities and with the majority of doctors and medical personnel of Chinese nationality. Foreign service suppliers may provide environmental services in the form of joint ventures, with foreign majority ownership permitted. Joint venture schools may be established, with foreign majority ownership permitted. Foreign educational service providers may not provide primary and secondary national compulsory education. China reserves the right to place national treatment restrictions on educational services.

China's WTO commitments will also widen the scope of operation of FIEs in the non-services sectors, especially manufacturing. A liberalisation of trading and distribution rights will enable FIEs to import and export on their own behalf and to distribute and service their products throughout China. All FIEs will enjoy national treatment in such matters as the pricing and availability of production inputs and discrimination against them in the business activities of the government and state-owned enterprises will not be permitted.

As part of its WTO accession agreements, China is committed to implementing the WTO Agreement on Trade-Related Investment Measures (TRIMs) in full from the date of accession. As a result, all trade performance, trade balancing, trade performance and local content requirements imposed on FIEs must be removed from laws and regulations pertaining to FDI. Foreign enterprises are accorded treatment no less favourable than that accorded to domestic individuals and enterprises with respect to: the procurement of production inputs and the conditions under which goods are produced, marketed or sold in the domestic market and for export; the prices and availability of goods and services supplied by national and sub-national authorities and public or state enterprises, in areas including transport, energy, basic telecommunications, other utilities and factors of production.

As described in more detail in 3.2, another FDI investment liberalisation initiative was the revision of the catalogues for guiding foreign investment industries that was previously promulgated at the end of 1997. Similarly as a result of WTO accession, new foreign bank licensing regulations were promulgated by the People's Bank of China (PBC) in February 2002 covering market access rights of foreign banks.

FIEs were previously denied full rights to import and export goods of all kinds (although they could always import machinery and production inputs for their own use and export their own products) by the imposition of such requirements as export performance, trade or foreign exchange balancing and prior experience as criteria for obtaining or maintaining the right to import

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and export. Since accession to the WTO, they are no longer subject to such import and export restrictions. Joint ventures with minority foreign ownership were granted full trading rights one year after accession, and joint ventures with majority foreign ownership will be granted full trading rights two years after accession. All enterprises, including those in the civil aircraft industry, will be granted full trading rights three years after accession, except for a few products, including such items as agricultural commodities and steel products, reserved for state trading enterprises.

Discrimination against FIEs or against imports in the making of purchases and sales by state-owned and state-invested enterprises is not permitted, nor may the Chinese government influence, either directly or indirectly, commercial decisions of such enterprises, including decisions on quantity, value or country of origin of any goods purchased or sold, in a manner inconsistent with WTO rules.

Finally, as part of its WTO accession agreements China is committed to implementing the WTO Agreement on Trade-Related Intellectual Property Rights (TRIPs) in full from the date of accession. China already has legislation in place governing copyrights, patents and trademarks; modifications were made to these laws in line with TRIPs. This legislation has a major bearing on FDI because China is more likely to attract FDI embodying technology transfer if intellectual property rights are effectively protected.

2.4. The evolution of regional FDI policy

The initial strategy towards FDI in the 1980s was to maximise FDI inflows to the whole country, initially to experimental zones remote from the capital but then to any areas favoured by foreign investors, without attempting to ensure even geographical distribution. This policy was encapsulated in the slogan "let some areas get rich first", a counterpart to the policy of letting some individuals and households get rich first, *i.e.* initially disregarding the regressive effects of economic growth on wealth and income distribution in society. It was therefore acceptable to the central government that the coastal region, starting with the SEZs, would benefit from FDI inflows while other regions received relatively little.

By the mid-1980s, representatives of hinterland provinces were complaining in the NPC that they were not benefiting from rapid economic growth and that, they were falling further behind the coastal provinces. From 1993 onward the government responded increasingly to such calls by switching to a policy of actively attempting to divert resources towards the Central and Western regions. As well as commencing major infrastructure initiatives, for example a programme to connect all villages to the road

system, the government also invited foreign investors to participate in this policy by investing more in the Western and Central regions.

3. The FDI project approval process and remaining ownership restrictions

3.1. Streamlining the project approval process

The procedures for examining and approving FDI projects involve an large number of administrative steps. These typically involve lodging documents with local branches of a number of different authorities, such as the State Administration of Industry and Commerce (SAIC), the State Administration of Foreign Exchange (SAFE), the customs authority and the NBS.

A serious problem is the co-existence of two sets of rules governing the approval process. National laws and implementing regulations are available to foreign investors, though not always in an instantly accessible form. These are described by Chinese officials as "*gongkai*" (public) rules. Accompanying these, there are other rules, characterised by Chinese officials as "*neibu*" (internal) rules, that are not published. This latter category includes rules that have traditionally been used by local authorities to decide whether or not a project will be approved. The Chinese national authorities state officially that internal rules at local level no longer exist. Because of their secretive nature, it is not known if there are also unpublished rules operating at national level.

Where internal rules grant benefits in addition to those to which an enterprise is entitled according to the published rules, the problem is less serious, provided such benefits are available to all qualifying enterprises (if they are only available selectively, or on a discretionary basis, then this amounts to discrimination). It is, however, likely that some of the internal rules are more restrictive than the published rules, to the detriment of potential investors that have done their best to meet approval requirements on the basis of publicly available information.

The application to establish an FIE must be submitted for examination and approval by the department under the State Council which is in charge of foreign economic relations and trade (the Ministry of Commerce, MOFCOM) or by other authorities entrusted with such powers by the State Council. The examining and approving authority must make a decision on whether or not to grant approval within 90 days of receipt of the application in the case of a wholly-foreign-owned enterprise, three months in the case of an equity joint venture and only 45 days in the case of a contractual joint venture. In all three categories of FIE, the foreign investor must then apply to the authorities in charge of industry and commerce for registration and a business licence within one month (30 days) after receiving a certificate of approval.

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The cut-off point between approval by central and local authorities is a project size of USD 30 million. Projects valued at more than USD 30 million must be submitted for approval to MOFCOM at national level and they will then be considered by the State Development and Reform Commission (SDRC, formerly the State Development Planning Commission, SDPC). Projects with a value exceeding USD 100 million must also be submitted to the State Council (China's cabinet) for approval.

Projects below USD 30 million may be approved by government departments at provincial level, including the governments of municipalities like Beijing and Shanghai directly under the State Council and autonomous regions such as Tibet. However, if a project is in an industry classified as restricted it must be submitted to higher authorities even if it is below the USD 30 million threshold. Conversely, it is in the encouraged catalogue and is regarded as not having future side effects it may be approved by the local authority and merely filed in the State Council offices even if it is larger than USD 30 million.

This division of authority is open to abuse in that it encourages local authorities to split projects valued at over USD 30 million into smaller segments to avoid having to submit them to national level authorities, a practice which is in clear breach of the rule. A project which is submitted only to local, not national, approval is more likely to be approved, as local authorities seek to maximise revenue and employment creation of FDI projects, while the national authorities have to take into account other factors (such as the perceived need to avoid localised overcapacity and overall macroeconomic considerations) which may cause approval not to be granted.

However, insofar as this stratagem of local authorities is efficiency-seeking rather than revenue-seeking, it does indicate the existence of real bottlenecks in the approval process. Local authorities complain that if a project is submitted to a central government department such as the SDRC the approval process will be delayed. While this delay generally averages about six months, which is already long by modern standards, in some cases it may be as long as three years, in which case the market for the product to be produced by the FIE may have changed and the project may be no longer viable. Another violation of the rules that may occasionally occur is that an FIE may go into operation before it has obtained approval to do so, evidently with the tacit, if not explicit, connivance of the local authority. This practice is another indication that project approval times tend to be too long.

The Chinese government may wish to consider amending the approval process to obviate unnecessary delays in the approval process caused by

submission of a foreign investment project to higher authorities. Possible solutions may include:

- Raising the limit above which approval has to be submitted to central government departments at national level and increasing the approval powers of local governments accordingly.
- Fast-tracking the national-level approval process by allocating more resources, including staff, to it, reorganising the process to make it more efficient, or both.
- Shortening the time limits for decisions on approval or non-approval by the examining and approving authority or authorities.
- Reclassifying projects from restricted to permitted or from permitted to encouraged, as appropriate, to ensure that they are submitted for approval at local, not national, level. (Unless the catalogues for guidance of foreign investment industries are further liberalised, as suggested in this report.)
- Standardising and simplifying the whole approval procedure.
- Making all changes transparent, for example by putting them all on the MOFCOM web site in both Chinese and English as early as possible.

3.2. The Catalogue for Guidance of Foreign Investment Industries

The Catalogue for Guidance of Foreign Investment Industries was promulgated on 11 February 2002 and came into force on 1 April 2002. As with the end-1997 revised catalogue that preceded it, it remains fourfold: encouraged, permitted, restricted and prohibited foreign investment projects. Only three catalogues are published, those for encouraged, restricted and prohibited projects. Projects that do not fall into the classifications listed in these catalogues can be presumed to be permitted.[12]

The main benefit of investing in a project that is listed in the Catalogue of Encouraged Foreign Investment Industries is that, apart from any preferential terms accorded it in other laws and regulations, it may enlarge its scope of business with approval, if it is engaged in the construction and operation of infrastructure facilities, such as fuel and power, transport networks or waste disposal, that require a large amount of investment and a long pay-off period. Projects in encouraged sectors may also benefit from lower income tax and value-added tax (in the form of rebates), may import capital equipment duty free, and may be allowed to borrow more than restricted-category investments. Other forms of encouragement are reportedly being considered.

The main disadvantage of investing in a project that is listed in the Catalogue of Restricted Foreign Investment Industries is that approval authorisation may not be delegated to lower-level authorities and may therefore take longer and run a greater risk that the project will not be

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approved. The Chinese authorities have expressed the view that the submission of restricted-catalogue projects to higher level organs for approval can not lengthen the approval process and does not involve an increased risk of non-approval. The Chinese authorities are also of the opinion that the approval process for restricted-catalogue projects is identical to that used for other project categories and is conducted according to identical principles.

The number of types of projects included in the 2002 Catalogue of Encouraged Foreign Investment Industries has been increased to 262 from 186 in the 1997 Catalogue. Encouraged industries include those using new or high technology; those in key sectors such as agriculture and infrastructure; projects that help meet both domestic and export demand; projects in Central and Western regions. Major changes in the 2002 Encouraged Catalogue include prospecting for and exploiting oil, natural gas and coal.

The number of types of projects included in the 2002 Catalogue of Restricted Foreign Investment Industries has been reduced to 75 from 112 in the 1997 Catalogue. This Catalogue includes projects that use dated technology, are perceived as wasting resources or are not good for the environment. It also includes industries which are being opened gradually to foreign investment.

The number of types of projects included in the 2002 Catalogue of Prohibited Foreign Investment Industries is similar to that of the 1997 Catalogue. Prohibited projects include those that endanger the safety of the state or damage social and public interests; those that pollute the environment, destroy natural resources or impair human health; those that occupy large amounts of arable land and are unfavourable to the protection and development of land resources; those that endanger the safety and performance of military facilities; and those that adopt unique Chinese craftsmanship.

The revised catalogues represent a major step forward in FDI regime liberalisation. The Chinese authorities are to be commended for this step and encouraged in their efforts to achieve further liberalisation by removing more categories of project from the catalogue of prohibited foreign investment industries. The inclusion of sectors where national control is considered desirable, such as projects that endanger the safety and performance of military facilities, is understandable; where not self-evident, an explanation of the reasoning involved would be helpful.

It is not clear that there is any benefit in maintaining an extensive catalogue of restricted industries that effectively raises the approval hurdle higher for a wide range of industries and services, including, it is important to note, most of the services sectors that are being opened as a result of WTO accession. The existence of the restricted catalogue necessitates the reference

of a project approval decision to a national authority (usually the SDRC). The national authority then decides on approval on the basis of criteria regarding national economic policy or other considerations which are opaque because they are not precisely specified in such a way that a foreign investor can make a reasonable effort to comply with them.

Abolition of the restricted catalogue in its entirety could be considered, at a time when the Chinese authorities judge further opening to foreign investment to be appropriate to the stage of development of the Chinese economy, as part of the next phase of liberalising the FDI catalogue regime.

Unlike the other two published catalogues, the encouraged catalogue does not restrict FDI in any way. The future of this catalogue will be largely determined by the Chinese government's policy regarding FDI-attracting incentives. One reason for questioning the need for the continued existence of the encouraged catalogue is the increasing length and complexity that has resulted from successive liberalisations and that will undoubtedly be exacerbated by further liberalisation. The list is now so detailed that many of the items are likely to become rapidly obsolete as a result of technological progress.

A clearer presentation of the permitted range of foreign investment activities could be achieved by replacing the catalogue regime with a single short list of sectors that are barred to foreign participation, supplemented by a clear explanation of the grounds for selection. All projects not on the list would then be permitted. As a transitional step towards wholesale reform of the catalogues, it would be good practice to reconsider the prohibition of foreign investment where the intention of controlling specific activities may be more effectively achieved in other ways, such as prudential regulation. The result would be the publication of a smaller prohibited catalogue containing only items which it is international practice to restrict or which China has a special and understandable reason for restricting.

China currently prohibits FDI in a few traditional crafts. The intention of this prohibition is presumably to ensure the continued existence of these activities because they are considered to be part of the national heritage. If this is the case, then the prohibition of inward financial flows supporting such activities would appear to be an inappropriate means of achieving such an aim, which might more effectively be pursued by other measures, for example by increasing the resources available for education and training in these fields.

The 2002 Catalogue of Encouraged Foreign Investment Industries retains from the 1997 Catalogue a final clause which includes permitted foreign invested projects whose products are to be wholly exported directly. Since the inclusion of a proposed foreign investment project in either the permitted or the restricted foreign investment list can determine whether or not it is

approved, this stipulation may be regarded as effectively imposing an export-performance requirement on such projects.

China has committed itself to a major opening of the banking sector to foreign participation. However, the resulting regulations promulgated by the PBC in February 2002 require such high capital requirements for setting up branches in China that only the largest foreign banks will be able to take advantage of the new market access opportunities. While the requirements for opening a representative office are relatively modest, those for establishment are much more strict: the parent bank must have USD 20 billion in total assets to open a branch and USD 10 billion to open a subsidiary. There are six levels of bank offices, with corresponding minima for operating funds in the case of branches and capital in the case of subsidiaries, in each case varying from 100 million to 600 million renminbi (CNY), or foreign currency equivalent. Considering that the regulations also include reasonable stipulations requiring foreign banks to be governed by adequate supervisory systems in their home countries and to possess adequate internal control systems, such high capital requirements appear disproportionate to guarantee stability and are interpreted by some representatives of foreign banking institutions as protectionism.

According to the Code of Liberalisation of Current Invisible Operations agreed by OECD countries, the total amount of any financial requirements imposed for the establishment of a branch or agency of a non-resident enterprise engaged in banking or financial services shall be no more than that required of a domestic enterprise to engage in similar activities. Furthermore, the total of the financial requirements to be furnished by all the branches and agencies of the same non-resident enterprise shall be no more than that required of a domestic enterprise to engage in similar activities. The minimum capital requirements in the foregoing paragraph apply only to foreign, not domestic, banks. Assessing the extent to which this might be considered as discriminating against the establishment of foreign banks in China is complicated by the lack of a firm basis for comparison, since there are no private banks in China and state-owned domestic banks are the subject of a different set of regulations.

Greater opening of the banking sector to foreign participation could be achieved by lowering the capital requirements for branches and subsidiaries of overseas banks to less discouraging levels, in accordance with OECD and other internationally recognised standards.

Another category of prohibited FDI is in the establishment of futures companies. There appears to be no advantage to be gained from banning FDI from entering this financial sector that could not be more effectively obtained

by imposing appropriate prudential regulation covering both domestic and foreign-owned enterprises.

4. Localised investment incentives and national/local policy coherence

China is a unitary state whose policies towards FDI are determined by the central government. However, administration has been greatly decentralised during the reform period. As a result, implementation varies widely between the various provincial-level units and also within provinces between smaller localities such as municipalities and SEZs. Insofar as there are major differences in policy between regions, these are a result of national policy to shift FDI, along with domestic investment, towards the less-developed hinterland.

FDI-attraction measures have taken a number of forms, including tax incentives, low land lease charges in comparison with other FDI target locations, provision of low-cost labour and the development of physical infrastructure. The initial aim of policy-makers was to convince foreign investors that it could be worthwhile investing in China despite the history of discouraging foreign investment before the reform period and subsequent deficiencies in the operating environment. Though it has offered labour at wages lower than those in FDI source economies, as one would expect from the wide difference in productive resource endowment between China and its more sparsely populated neighbours, China does not appear to have concentrated on engaging in bidding wars to divert investment away from competing FDI recipients.

4.1. Tax incentives to attract FDI

Tax legislation regarding FIEs consists of a complex tax incentive system as a tool of the government to attract FDI in pursuit of national development priorities. Most of these incentives are not available to Chinese enterprises. Currently, 14 taxes relate to foreign investment, including corporate income tax, personal income tax, value-added tax (VAT), business and consumption taxes. Fees are also imposed by local governments. Other compulsory payments include social security contributions, mainly to pension funds and health insurance schemes. VAT is the largest single source of revenue. The Chinese tax system therefore differs from tax structures in OECD countries, where personal income tax is the largest single revenue source, followed by social security contributions.

The 33 per cent corporate income tax rate may be reduced to 15 or 24 per cent, depending on the geographic location and the type of foreign investment. Generally the 15 per cent rate is applicable to FIEs located in SEZs,

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high-tech companies located in special technology zones and companies engaging in specifically designated industries in the Western and Central regions. The 15 per cent rate can also be applied to production-oriented FIEs located in open provincial or port cities, provided the enterprises are engaged in high-tech industries. The 24 per cent rate applies to production-oriented FIEs located in open coastal economic zones or in port cities. When an FIE has affiliates in different locations, it may be the case that each branch is taxed differently, at the rate applicable in that particular location.

China offers FIEs a five-year preferential tax regime that consists of two years of tax exemptions followed by a 50 per cent reduction of the general corporate income tax rate for three years. However, this holiday is applicable only to FIEs engaged in production-oriented activities for at least ten years. The five-year concessional period starts to run from the first profitable year and continues for five consecutive years, regardless of subsequent profitability. A tax holiday may additionally be available for investments such as those in export-oriented enterprises, technologically advanced enterprises, or investments in port and wharf development. This entitles the FIE to a further tax reduction after expiry of the initial five-year concessional period. The standard concessions for a company thus include a top income tax rate of 15 per cent which only comes into effect in a company's sixth full year of profit-making after a two-year tax holiday and three years at 7.5 per cent income tax.

The Chinese government has since 1994 been carefully studying the question of whether the two separate tax regimes for domestic and foreign enterprises should be merged. Discussions have intensified in the light of WTO accession. The then Finance Minister, Xiang Huaicheng, announced in June 2002 that income tax for foreign-funded and domestic firms would be unified in 2003; however, the standard rate of tax that will then apply has not yet been made public. The long-expected policy change is a response to the increased financial strains experienced by domestic Chinese companies in recent years. Competitive pressures have led to corporate restructuring and layoffs. Now that it has acceded to the WTO, China is less able to protect its inefficient state-owned enterprises. In addition, the decrease in import tariffs agreed to in the WTO accession agreements will reduce government revenue. Once it has been decided, implementation of the unification of the two income tax regimes will take time to accomplish.

A unified tax system for all enterprises irrespective of national origin would comply with the principle of tax neutrality, thus reducing incentives to take advantage of the current dual-track system. It could well produce unintended effects, especially regarding Chinese enterprises.

Chinese companies appear to welcome the establishment of a "level playing field" which would improve their competitive position, especially in the case of financial institutions. The main concern of FIEs is to ensure that concessions already extended will not be revoked retroactively, but protected by grandfathering clauses.

Some foreign enterprises claim that the difference between the current effective tax rates for Chinese and foreign-owned enterprises are not as far apart as the income tax rates indicate, since their domestic competitors, whose financial procedures are less standardised, may enjoy other privileges, such as budget subventions or cheap loans, some of which may not comply with existing legislation. On the other hand, some Chinese entrepreneurs claim that this practice is a natural by-product of the current unequal tax regimes. Other Chinese companies who pay their corporate income taxes as a contracted lump sum argue that the change in the tax rates would not greatly influence their financial situation.[13] Foreign investors may therefore worry that domestic companies might end up being privileged after the tax merger if the above practices persist.

Any attempt to close the gap in income tax rates between foreign and domestic enterprises would also have an effect on those so-called "FIEs" which are in fact domestic enterprises engaging in round-tripping.

Any change in FDI incentives will concern some local companies to the extent that they benefit from tax reductions as a result of their involvement as Chinese partners in Sino-foreign joint ventures,. Local governments reportedly offer fiscal concessions to FIEs beyond the limits allowed by the central government, partly in order to attract FDI and perhaps also with the intention of conferring fiscal advantages on local enterprises which are joint venture partners.

Foreign companies have also tried to seek loopholes in the system: to ensure that they will continue to benefit from tax concessions. For example, some FIEs have closed their facilities in one location and opened others elsewhere.

The effect of the disappearance of tax incentives on companies based in the United States may be less than on companies based elsewhere. The United States' tax treaty with China does not include a "tax-sparing" provision to allow a credit against the home country's taxation on the income of its businesses in China, so that such businesses can not offset the tax paid in China against their tax liability in the United States and are therefore effectively taxed at the same rate whether or not they are subject to incentive tax reductions in China. Such companies can, however, benefit from tax incentives if they do not repatriate their profits but instead reinvest them in China or send them to a subsidiary based in a third country, because in either

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case such profits are not taxable in the United States. It is not clear whether the lack of a "tax-sparing"provision has had any major impact on the decisions of companies in the United States to invest in China. A recent OECD study found that the FDI sensitivity of United States companies to a given amount of tax relief was difficult to estimate precisely.[14]

What would be the fiscal effects of a merger of the two tax regimes? From the viewpoint of foreign investors, it would be disadvantageous if the standard rate were not lowered, but set at 33 per cent (or raised above that), while rendering FIEs liable to that rate. From the viewpoint of the Chinese government, the consequent increase in tax revenue would depend on the inelasticity of response by foreign investors, which may be quite large. Tax considerations can break, but do not usually make, a decision as to whether a foreign company should invest. Even if investment decisions already taken remained unchanged, the increase in tax revenue would not be very large as a proportion of the government budget, considering that the contribution of the corporate income tax paid by companies with foreign status to the budget was only 2.2 per cent in 1999.

4.2. Regional incentives for domestic and foreign investment

From the mid-1990s, the government has encouraged FDI flows into the Central and Western regions as part of its policy of attempting to spread the benefits of economic development to China's vast interior. In 1996 the government raised the project approval limit of provincial authorities in the Western region to USD 30 billion to bring it in line with that of the open coastal areas. Additional incentives to direct FDI more positively to the Western region began in 1999.

Incentives are provided to attract FDI to both the Central and Western regions, but more incentives are available for the west than for the centre. While specific incentive provision is made for the Western region as a whole, the Central region is understood to be covered mainly by provincial-level measures.

In addition to the national catalogues for guiding foreign investment industries, the government has published a Catalogue of Advantageous Sectors for Foreign Investment in the Central and Western Regions. Projects included in this catalogue enjoy the same treatment as those in the catalogue of encouraged projects.

A major emphasis of policies designed to attract FDI to the Western region is on the construction of basic infrastructure facilities. Foreign investors are encouraged to invest in infrastructure projects in agriculture, water conservancy, ecology, transport, energy, municipal administration, environmental protection, minerals, tourism and resource development.

FDI is also encouraged to contribute to the development of services sectors in the Western region. The regulation adopted in 2000 outlining the opening of sectors such as banking, retail and foreign trade, initially only to pilot projects, has, however, been largely overtaken by the WTO commitments entered into by late 2001, which specify a more comprehensive opening of these sectors nationwide.

Restrictions on the operation and financing of FIEs are less strict in the Western region, but the terms of relaxation have been left vague in the relevant regulation. The forms of foreign investment in the Western region may now include build-operate-transfer and transfer-operate-transfer, though initially only on an experimental basis. Foreign-invested projects may be partly financed in renminbi and financing by initial public offering (IPO) is encouraged if the projects concerned are qualified to do so. Equity holding restrictions on foreign-invested projects in infrastructure construction and priority industries in the west "will be relaxed", though the precise form of this relaxation is not specified in the regulation.

Current research supports the proposition that localised incentives have been positively associated with FDI inflows, but only as one among several independent variables. One econometric study using a panel framework shows that contracted FDI in a survey of 28 of China's 31 provincial-level administrative units is positively influenced by the level of international trade, R&D manpower, GDP growth, infrastructure, and the availability of information and of incentives.[15] However, this study explicitly omits (for reasons of data scarcity) an econometric investigation of the regional distribution of FDI in China in relation to its geographical sources. There is no doubt that this factor has played a major role in the location of FDI, as is evident from the pattern of investment from Hong Kong (China) (largely in neighbouring Guangdong), Chinese Taipei (disproportionately high in Fujian, which faces Chinese Taipei across the Taiwan Strait), South Korea (mainly in nearby Shandong) and Japan (mostly in areas of China that received investment from Japan before the second world war, such as Dalian, Shanghai, Jiangsu and Zhejiang).

The conclusion of the study quoted above is that FDI in "the inner areas" (*i.e.* the Central and Western regions) can be expected to "increase quickly". This is based on the twin assumptions that government infrastructure construction will improve the investment environment sufficiently to provide a workable environment for investment projects and that the incentives now in place will be more effective than in the coastal areas, since the hinterland lacks several of the variables (for example, high level of international trade, R&D manpower) present there.

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Another recent study showed that the Eastern region remained the most popular FDI destination for the 680 foreign companies surveyed.[16] Of those respondents already operating in China, 56 per cent were located in Shanghai, 46 per cent in Beijing, 18 per cent in Shenzhen and 17 per cent in Guangzhou (some companies operate in more than one location). A small shift in location is discernible from the plans of those not yet operating in China, 54 per cent of whom intended to put their investment in Shanghai, 30 per cent in Beijing, 9 per cent in Shenzhen and 6 per cent in Guangzhou. However, the latter figures still demonstrate an overwhelming preference for the Eastern region.

It is unrealistic to expect a major diversion of FDI from the Eastern region to the Western and Central regions until the difference in infrastructure endowment has been greatly evened out, a process that will take decades, not least because the coastal provinces are continually upgrading their own facilities. The cities of the Eastern region have large populations that will continue to grow, especially after the eventual abolition of the *hukou* (household registration) system, which restricts population movement. They are therefore in a better position than the hinterland to pay for infrastructure improvement and to call upon central funds for the same purpose. Foreign investors remain sceptical about the attractions of hinterland provinces, where the market for their products and services is much thinner than in coastal cities because populations are smaller and incomes far lower. They are also wary of entering regions where skilled labour is scarce – and therefore relatively expensive – as young and well-qualified workers migrate eastwards in search of higher-paid employment and a greater variety of occupational opportunities.

To the extent that the investment incentives available to FIEs are the same as those on offer to domestic enterprises, the policy of attracting capital investment to the Western and Central regions is consistent with the principle of national treatment. However, such incentives do not constitute a sufficient condition for increased investment in those regions. If the Chinese government wishes to redirect investment westward, it may prefer to put the main emphasis on improvements in the business environment. The current policy of allocating state funds to infrastructure construction in the Western and Central regions can be considered part of this effort. Institutional development is also necessary, in particular an initiative to raise the standard of investment promotion and investment approval in these regions to that prevailing in the open coastal zones, which are generally much more flexible in their interpretation of FDI laws and regulations. More officials in the Western and Eastern regions may, for example, be encouraged to visit their counterparts in SEZs and other open zones to experience and understand the procedures that have been so successful in attracting investment there. Such

measures would be relatively cost-effective and would retain their relevance even if the "invest in the West" policy were modified.

5. State-owned enterprise reform

The competitive environment in which both FIEs and domestic enterprises operate in China is still evolving. China's accession to the WTO and its international commitments to open and transparent FDI policies more generally will provide a major impetus to remove barriers to competition, which have hitherto been acute as local authorities, industry ministries and large SOEs have been able to use administrative monopolies and regional protectionism to exclude foreign investors. In particular, China can achieve sustained economic growth from foreign participation in the process of restructuring its inefficient SOEs. For this to happen, the regulatory and informational environment will have to be further improved so that foreign investors are able to gauge accurately the profitability of domestic enterprises and, if appropriate, participate in some form of M&A activity with them.

5.1. The private and state-owned enterprise sectors

SOEs, though no longer dominant, retain a major role in the Chinese economy, while the private sector, virtually nonexistent at the beginning of the reform era, is increasingly firmly established as an important provider of goods, services and employment.

The private sector in China is difficult to define, since some of the categories employed by statisticians are ambiguous, ownership rights are often unclear, and categories such as Sino-foreign joint ventures may include both public and private ownership. It is nevertheless possible to trace the development of the private sector in broad terms by aggregating the non-state, non-collective sectors, including not only officially-designated private enterprises but also limited liability companies, shareholding companies, self-employed individuals and foreign-funded enterprises, including enterprises funded by investors from Hong Kong (China), Macao (China) and Chinese Taipei. So-called "individual" or household enterprises may have started as one-person businesses, but have often grown into larger units that would be classified in other economies as private enterprises.

This loosely-termed aggregate "private sector" accounted for only 0.8 per cent of total urban employment in 1980 (Table 3), in the form of 150 000 self-employed individuals. By 2000 it had expanded to nearly a quarter. Moreover, it is likely that these figures understate private-sector employment, since they are increasingly incomplete; non-state employment is more likely to be difficult to capture in official statistics, so the missing employees are more likely to be in private-sector than SOE employment. Since a rising proportion

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of foreign-funded enterprises are wholly-foreign-owned enterprises, with the foreign ownership usually private-sector, the figures are likely to understate rather than overstate the participation of private enterprise in the Chinese economy, since they do not distinguish between different forms of foreign-funded enterprises.

Table 3. **Employment as a proportion of total urban employment, 1980-2000**
(per cent)

	SOEs	Collective enterprises	Private enterprises	Limited liability companies	Share holding companies	Foreign funded enterprises	Hong Kong, Macau and Taiwan funded enterprises	Self-employed individuals
1980	76.2	23.0						0.8
1985	70.2	26.0						3.5
1990	62.3	21.4	0.3			0.4		3.7
1995	59.0	16.5	2.5		1.7	1.3	1.4	8.2
2000	38.1	7.0	6.0	3.2	2.1	1.6	1.5	10.0

Source: National Bureau of Statistics, *China Statistical Yearbook*, 2001.

The most striking increase in private-sector employment has been in the "self-employed" sector, which now employs 10 per cent of urban employees. Because of time lags in reclassification, this category in practice is likely to include at any time a number of enterprises which have grown rapidly beyond the original scale of operation. Limited liability and shareholding companies, which did not exist before the 1990s, now already employ over 5 per cent of urban employees. Foreign-funded enterprises of all kinds employ over 3 per cent, but are doubtless responsible for a far larger segment of employment if associated enterprises involved in such tasks as distributing the products of foreign-funded enterprises are included.

The relative contribution of SOEs to industrial production has declined in line with, and initially rather faster than, their proportion of urban employment. At the beginning of the reform period, virtually all industrial output was from SOEs or collectively-owned enterprises. By 2000 the share of SOEs had fallen to 47.1 per cent and that of collectively-owned enterprises to 13.8 per cent, while that of foreign-funded enterprises (including those funded by investors from Hong Kong (China), Macao (China) and Chinese Taipei) exceeded 27 per cent and production by shareholding companies approached 12 per cent. Comparing these figures with the relatively tiny proportion of employment directly employed by FIEs, it is clear that the latter are characterised by far higher productivity of labour than the other categories.

Official statistics suggest that shareholding enterprises were the most profitable. While such enterprises produced 11.7 per cent of output (and employed only 2.1 per cent of the urban workforce), they were responsible for 23.2 per cent of profits, indicating that they were roughly twice as profitable as SOEs. These figures are of course aggregates and do not show the wide variety in profitability in each category of ownership. The SOEs, in particular, range from firms that have already established themselves in world markets to loss-making enterprises that are destined to disappear in a more competitive environment.

At the beginning of the reform period, SOEs accounted for over 80 per cent of total fixed asset investment; by the end of the century this share had fallen to 50 per cent. Enterprises with individual ownership increased from 13.1 per cent of fixed investment in 1980 to a peak of 23.4 per cent in 1989 before falling back to 14.3 per cent by 2000. Enterprises in the "other category", including FIEs and private enterprises of various kinds, doubled in the period 1993-2000.

Measured in terms of financial appropriation, SOEs accounted for a smaller proportion, 41.7 per cent, of total fixed asset investment in 2000, while FIEs (including those with investment from Hong Kong (China), Macao (China) and Chinese Taipei accounted for 6.6 per cent and shareholding economic units 10.3 per cent. The low proportion of FIEs in fixed asset investment compared to their share in total output suggests that these enterprises are more efficient in terms of capital:output ratio than domestically-owned enterprises of all kinds.

5.2. State-owned enterprise reform

After its highly successful reform of the agricultural production system in the early 1980s, the Chinese government turned its attention in late 1984 to reforming the state-owned industrial system. Whereas the establishment of the rural responsibility system had entailed effective privatisation of agriculture (though not of land, which remains state-owned in urban areas and largely collectively-owned in the countryside) by breaking up the collective structures imposed after the completion of land reform in the early 1950s, the government maintained the view that state ownership of industry was an essential component of the existing political system which could not be jettisoned, so privatisation was ruled out. The initial approach was therefore to alter management structures and incentives to render the SOEs more efficient.

Industries were vertically organised into monopolistic groups headed by government ministries, largely ruling out domestic competition. Competition from imports was not yet significant, since import penetration was still

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relatively limited (merchandise imports were only 6.6 per cent of GDP in 1980, compared to 20.8 per cent in 2000). Since prices were controlled by the state, they were unable to act as market signals. The quantity and composition of output were not decided by managers but by the central planners in the State Planning Commission (SPC, renamed SDPC, in 1998 and reorganised into the State Development and Reform Commission, SDRC, in March 2003, when the word "planning" was at last dropped from its title), which had formulated five-year and annual top-down production plans based on the Soviet model since 1953.

Lacking control over output and pricing decisions, and with accounting systems intended merely to encourage input minimisation, managers had neither the information systems nor the stimuli to enable them to maximise profits. As a result, many SOEs made losses and depended for their survival on subsidies from the central budget. After such subsidies were phased out, they were replaced by loans from the state-owned banking system which were in many cases not repaid or even serviced. SOEs have throughout the reform period thus enjoyed a "soft budget constraint" in the form of permissive financing which enabled them to survive chronic loss-making.

Since the mid-1980s, a number of SOE bankruptcies have occurred, but these have been far fewer than would have been the case if the authorities allowed all insolvent SOEs to do so. A major reason for keeping inefficient enterprises alive by subsidies or by restructuring is that they provide employment to large numbers of workers and so help to bolster social and political stability.

The government has tolerated such inefficiency largely because SOEs acted as major providers to their employees of basic services such as housing, healthcare, education and social welfare. Closure of an SOE can therefore only be contemplated if alternative provision is available. Such alternatives are gradually being established, but this is a slow process. Housing reform is now well under way; factories may no longer allocate housing units to their employees and a small but increasing number of urban families are buying their own apartments. Social welfare schemes have been set up in most localities, though some are experiencing funding difficulties, since provinces where the need is greatest tend to be those where fiscal resources are most limited.

The other major unfunded SOE liability is pension rights, which are more generous than in many other countries, in some cases reaching as high as 100 per cent of salary replacement. Pension payments in 2000 exceeded CNY 230 billion after having grown at an average annual rate of 26.4 per cent during the 1990s. Many SOEs have not had sufficient income to maintain pension payments, and, in some cases, wage payments to underemployed employees.

Although SOE employment has fallen from its peak, it remains large in absolute terms. A further shake-out of surplus labour would add to unemployment at a time when it is already a large and chronic problem in the overall economy. In rural areas efficiency gains from the implementation of the rural responsibility system in the 1980s have produced a "floating population" of unemployed estimated to number between 100 million and 200 million. Urban unemployment, officially enumerated at 3.1 per cent in 1997-2000, is in reality far higher, largely because of the restricted definition of unemployment used in China.

Gradual progress has been made in 16 years of SOE reform. First of all, the business environment in which SOEs operate has been transformed. The central planning system has been relaxed to the extent that although five-year plans are still published by the government they have, since the mid-1990s, become indicative rather than mandatory. Output decisions are now in the hands of the SOEs, which also now have autonomy in purchasing inputs and selling products. Prices are no longer set by the state, but are determined by the market. The enterprise can, in most cases, use its retained earnings as it sees fit.

State-owned enterprises have lost their monopoly power over many consumer markets, especially those that have long been open to FDI. Competition with world-class producers has stimulated a diversification of product range, an improvement in product quality, and greater efficiency in production processes. As a result, a number of SOEs have become major exporters, especially in consumer durables sectors.

At the 1993 Communist Party National Congress it was decided to transform the SOEs into limited liability and joint stock companies by means of "corporatisation" (*gongsihua*) as part of a programme to establish a "modern enterprise system". The intention was clearly to promote the autonomy of SOEs to enable them to orient their decision-making towards the market rather than to continue to take direction from government authorities. However, since such authorities retained controlling shareholdings, there was in practice no major alteration in the actual running of SOEs.

Especially in the past six years, the pace of SOE reform has been considered too slow by the government, which is concerned at the persistence of the chronic problem of nonperforming loans to SOEs by the state-owned banking system. An equally important problem was the drain on government finances that SOEs entailed by their low profitability. Direct subsidies to loss-making SOEs have fallen since their 1989 peak of CNY 60 billion, but remain high, for example CNY 28 billion in 2000 (though this was greatly exceeded by tax revenue from profitable SOEs). As subsidies have been replaced by loans, the main fiscal problem is inadequate tax revenue resulting from the poor

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performance of many SOEs. The potential danger of a banking collapse began to appear more acute after the onset of the Asian economic crisis in July 1997. At the Communist Party National Congress held later that year it was decided to implement a shareholding system for SOEs and to sell off small and medium-sized SOEs to the private sector.

Since the mid-1990s, SOEs have been transformed into corporations of various kinds. Large-scale SOEs generally acquired autonomy from the state by transmuting themselves into listed companies, while small and medium sized enterprises were disposed of in various ways that removed them, together with their financial obligations, from local government account books. (The majority, 72 per cent, of firms owned by local governments were in the red in 1995.)

While wholesale privatisation of SOEs has been ruled out by the government, privatisation of small and medium sized SOEs in accordance with the principle of "grasping the big and releasing the small" started in the mid-1990s and has gathered pace in recent years. According to the State Economic and Trade Commission (SETC),[17] quoted in a recent World Bank study of corporate governance,[18] over 80 per cent of small and medium sized SOEs had by 2000 been "transformed" in that they had been restructured, merged, leased, contracted, turned into joint stock companies, sold or been declared bankrupt. Most of these were in fact bought by managers and/or employees, a solution that was more ideologically acceptable than outright privatisation or sale to foreign investors. While the dispersion of ownership may initially have provided an incentive for the workforce to improve the performance of the firms in which they worked and in which they had acquired a direct interest, in the longer term there appears to have been excessive dividend distribution resulting in inadequate capital investment and a failure to strengthen performance monitoring and participation in decision making. The diffused ownership structure gave inadequate control rights to employees who had power over key resources such as technology. Many such employees left to form their own enterprises, sometimes taking the technology with them.

The perceived failure of employee buy-outs has led local governments and enterprise managements to attempt a second wave of restructuring aimed at concentrating shareholding in the hands of managers and key employees. To the extent that this has succeeded, it has replaced the problem of excessive diversification with that of insider control, which may threaten the rights of minority shareholders.

An important feature of SOE reform in China is that the government intends to create 156 internationally competitive industry groups ("national champions") by merging existing enterprises into large diversified groups

capable of cross-subsidising their operations to support large-scale investment in export manufacturing capacity and high technology. This strategy is largely modelled on the Korean government's nurturing of the *chaebol*. To the extent that less profitable or unprofitable SOEs are merged with highly profitable SOEs, this policy is likely to give new life to soft budget constraints. It also threatens to stifle competition in markets dominated by the new groups. Taking into consideration the difficulties facing merger and acquisition attempts by FIEs and also the lack of "trust busting" or other competition laws, this process of domestic industrial agglomeration may appear to constitute a form of effective protectionism.

5.3. Implications of SOE reform for FDI

SOE reform offers interesting opportunities to foreign investors. Foreign investors will play an increasingly important role in restructuring of SOEs, increasingly by acquiring such companies, in whole or in part, or their assets. Doing so promises benefits such as increased access by foreign investors to market sectors hitherto dominated by SOEs.

The reform of state-owned industry and the development of private-sector forms of enterprise necessitate improvements in corporate governance and accounting standards which are also supported by the correction of defects in the banking system and the development and opening up to foreign investors of capital markets. As these improvements take shape, foreign investors will benefit increasingly from greater transparency in their dealings with joint-venture partners and other entities with whom they do business.

The business environment has already benefited greatly from the removal of the main mechanisms of central planning such as price and output controls. SOE monopoly power persists in some sectors, but in others it has been eroded by the entry of FIEs and private enterprises. Provided the government fulfils its WTO accession obligations in this respect, foreign investment will suffer less from uncompetitive practices such as subsidies to domestic producers.

Improvements in the regulatory environment and the development of a sounder financial system will also benefit domestic companies, including both the better-organised of the SOEs and the private-sector companies. The government may will succeed in its aim of build some domestic corporations into global brand names, and these will provide stiff competition that will compel FIEs to continue with product and process improvements.

Since China is a both a developing country and a transition economy, the process of economic reform has so far been pragmatic. However, Chinese corporations are now facing problems that are increasingly complex but for which there is often an available solution in more developed countries. The

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corporate consultancy market will therefore continue to grow in China, providing opportunities for multinationals based elsewhere to sell their expertise and experience there.

6. The competitive environment for FDI

6.1. Corporate governance

If foreign investors are to play a full part in the restructuring of Chinese industry by developing relationships with existing domestic corporations, whether privately-owned or state-owned, improvements in corporate governance practices are necessary. Although the Chinese government has established a framework of laws and regulations designed to ensure sound corporate governance, better implementation of existing rules is perceived as a key factor in strengthening corporate governance in China. Improvements are needed on many fronts, but of particular interest to foreign investors is to progress with reforms in the areas of transparency and disclosure and in reducing state interference in corporate affairs.

The corporate governance system is based on the Company Law that was promulgated on 29 December 1993 and amended on 25 December 1999, on the Code of Corporate Governance for Listed Companies in China adopted on 7 January 2001 and on regulations and guidance documents issued by government bodies including the China Securities Regulatory Commission (CSRC), SETC and the Ministry of Finance. The other major piece of legislation whose provisions have some bearing on corporate governance is the Securities Law promulgated on 29 December 1998.

The Code of Corporate Governance for Listed Companies in China was issued jointly by CSRC and SETC on 7 January 2001. The Code, which is inspired by OECD principles, applies to all listed companies within China and is used as a standard to measure corporate governance performance by the CSRC, making it a major determinant of whether or not a company fulfils listing requirements on China's stock exchanges. A special inspection was introduced in 2002 to check companies' compliance with the Code.

CSRC issued a Guideline on the Management of Listed Companies on 7 January 2002. The aim of the Guideline is to encourage domestically listed companies to establish and develop a modern enterprise system; regulate the operations of domestically listed companies; and promote the healthy development of the securities market. The Guideline lists the basic principles on the governance of domestically listed companies, the measures needed to protect the interests of investors and the behaviour and professional ethics of the directors, members of the supervisory committee, and managerial staff of listed companies.

A number of serious problems with corporate governance of limited liability and joint stock companies have been identified by regulators and by outside commentators.

Boards of directors usually consist largely of executive directors, with very few independent directors. The board of directors is thus subject to "insider control" (*neibu kongzhi*) and is unable to monitor the company's executives effectively. Boards of supervisors may report to shareholders' meetings, but their role is effectively nullified if the shareholders' meetings are dominated by the controlling shareholder (usually the state), who may also control the board of directors. It is, therefore, vital to enhance the role and independence of boards and ensure that minority shareholders are represented on boards of directors.

Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies were issued by the CSRC on 16 August 2001. These Guidelines require at least one-third of board of directors to be independent directors by June 2003. Independence in this context is defined as being independent of management and of relatives of the management, of the controlling shareholder (which is usually the state) and of persons providing financial, legal or consulting services to the company. Candidates must be verified by the CSRC in each case before a director can be considered for appointment as an independent director. Candidates must declare their independence publicly and the declaration must be published in the newspapers. By the end of June 2002, 2 327 independent directors had been appointed by shareholders' meetings; 80 per cent of the 1 084 companies had at least two independent directors on their boards (not too far short of the interim target of 100 per cent set for that date in the Guidelines), and 70 per cent had at least one accounting professional as an independent director. The Guidelines also stipulate that listed companies must provide adequate working facilities for independent directors and that they can not dismiss independent directors without good cause (such as failure to attend three consecutive board meetings).

In 2001 classes to train independent directors began in Beijing and Shanghai; in the ten months to the end of June 2002, 5 000 candidates for independent director positions had been trained in these. The Shanghai and Shenzhen stock exchanges are also mounting courses for existing directors. By 2005 all directors will have attended training classes. Training programmes for investors are also being organised in major cities and on the Internet.

The state still holds at least half the shares of all listed companies (some estimates range much higher) and the largest shareholder, usually the state, tends to hold about 45 per cent of the shares of each listed company. It is often not clear who represents the state and who has control over state-owned

assets, since state control of the original pre-corporatisation SOEs was vested in various levels of government. State control is also linked to the influence of the communist party. Communist party committees in listed companies are also reported to retain influence that is not always wholly transparent, for example in regard to controlling membership of boards of directors. Large state shareholdings also require a clear distinction between the state's two roles as shareholder and regulator.

Recent research findings suggest that company performance would be likely to improve if state shareholdings were gradually replaced, including by large institutional shareholdings. Reducing the role of the state in corporate affairs in this way is difficult at present, as only about one-third of shares are traded on the stock exchanges, the rest consisting of non-tradable shares. The development of institutional shareholder involvement has been a slow process in OECD countries and may take some years in China. Institutions have to be careful with their choice of good quality financial products and therefore demand high standards of corporate disclosure and transparency. It is thus not surprising that institutional investors, most of them held wholly or in part by the state, currently hold a mere 2.3 per cent of market capitalisation. Institutional investors can play a vital and independent role in stimulating improvements in corporate governance, but only if they are fully empowered to do so in a system that provides full rights to shareholders. The entry of foreign institutional investors can be a major catalyst for change in this regard.

Related party transactions between the controlling shareholder, or the holding group to which the company belongs, and the company are common, often against the interests of the company and minority shareholders in particular. One OECD study of corporate governance in China[19] identifies related party transactions as the "key threat to shareholder value". They are aggravated by the need to maintain a vast array of social assets and services at the parent level and by politicised resource allocation decisions. Such practices may be concealed and exacerbated by the lack of transparency alluded to below.

Since the state controls many companies, it also appoints and controls their executive managers, a practice which is not necessarily a great improvement on that which prevailed under the former system of central planning. Since managers are routinely regarded as civil servants, managerial salaries tend to be low and unrelated to performance. There is therefore little incentive for managers to improve. This problem is particularly acute in poorer hinterland areas where it may be difficult to consider the possibility of paying a manager more than the local officials who may be involved in appointing him or her. Stock options can not be substituted for incentivised

salaries as they have as yet no legal basis. This situation, though, will change as provision for stock options is expected to be included in future legislation.

Information is not generally disclosed accurately, on time or in a form understandable by shareholders. The statistical system of SOEs was designed to produce information on the fulfilment of output plans. During the reform period it has metamorphosed into a system that is intended to supply data for the calculation of enterprise income tax. Managers of both listed and unlisted companies therefore have little or no practical experience of the type of financial information that should be provided to shareholders and the public (*i.e.* potential investors). There are also strong incentives to distort and manufacture information, often stemming from the loyalty of management to parent companies who may be benefiting from related party transactions which entail a diversion of funds that may in some cases be detrimental to the profitability of the company concerned.

The problem is equally severe on the demand side. Shareholders tend on the whole to be unfamiliar with such techniques as ratio analysis of listed companies. One reason for this is inexperience: Chinese stock markets are still in their infancy, there are few experienced professional analysts and institutional investor involvement remains minimal. Another reason is that investors tend to expect, not entirely without foundation, that share values will be supported by the state. The stock market at present tends to fall somewhat short of the task of providing a wholly objective standard by which to value companies. This lack of transparency may tend to weaken the use of stock market valuation as an incentive to optimise company performance. One study has even shown that IPOs by SOEs are more likely to worsen than improve the performance of the enterprises concerned.[20] This is because companies tend to submit inflated figures in the financial statements they are required to provide, concealing their real situation until well after they have secured a financial listing.

6.2. Accounting standards and regulations

China has made enormous progress in developing accounting systems and standards that conform increasingly to internationally recognised standards. The opening of the accounting sector to foreign participation is likely to stimulate further improvements.

In creating an institutional framework for business accounting the government had to start from scratch in the late 1970s. The Soviet-type accounting system developed in China in the 1950s was designed to meet the needs of a centrally-planned economy with enterprises operating the "cost accounting" (*khozrashchet*) system. The accounting function was essentially reduced to bookkeeping for statistical reporting and cost reduction purposes,

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using standardised procedures that required no judgment. As a result, there were no certified public accountants (CPAs) and no professional body representing accountants at the beginning of the reform period. Financial information relevant to business planning was not collected, since no consideration of profit and loss was made in the command economy, nor could the data that was available be used for such a purpose. Independent auditors and regulators did not exist.

The Accounting Law of the People's Republic of China, adopted in January 1985 and amended in December 1993, provides the main legal basis for accounting, but not in excessive detail (it consists of 30 articles). The law lacks precision on some counts, for example in stipulating that accounting personnel must have "necessary professional knowledge", without mentioning any specific vocational qualifications. Imprecise specification may to some extent be deliberate in that the law allows enterprises a degree of flexibility in designing accounting systems that is an express element of government policy.

Under the law, the Division of Administration of Accounting Affairs (DAAA) of the Ministry of Finance is responsible for setting accounting standards that all companies must follow. The first such standard, the Basic Accounting Standard (BAS), based on the International Accounting Standards issued by the International Accounting Standards Board, was promulgated in 1992 and implemented formally in 1993. In the same year, the Ministry of Finance set our a new uniform accounting system in line with the BAS to replace the existing Soviet-type accounting system. In 1993, the DAAA published the Accounting Standards for Business Enterprises (ASBE) and the DAAA has since been developing specific accounting standards and regulations under the ASBE. In 1998 an Accounting Standards Department responsible for developing accounting standards, subject to approval by the Ministry of Finance, was established in the DAAA.

The Chinese Institute of Certified Public Accountants (CICPA) was established in 1988 under the Ministry of Finance and now has 135,000 members. Since 1997 CICPA has been a full member of both the International Federation of Accountants (IFAC) and its regional offshoot, the Confederation of Asian and Pacific Accountants. Through membership of these bodies, CICPA works to harmonise China's accounting practice with internationally recognised standards. CICPA works under the joint guidance of the Ministry of Finance and the National Audit Office. Like similar bodies in other countries, it sets standards, organises training and the national CPA examinations and registers CPAs. The CICPA promulgated its first set of Independent Auditing Standards in 1995. It also decides on the admission of foreign accounting firms into China and supervises and regulates them after

admission. CICPA members must state in their audit reports whether or not the company being audited has complied with the ASBE.

The seven-member Chinese Accounting Standards Committee, which advised the Ministry of Finance on issues related to the promulgation of accounting standards, was inaugurated in 1998.

Initially the government allowed ministries and enterprises to set up their own accounting firms to fill the vacuum. Then from 1992 onward it forced accounting firms to separate from their parent organisations and merge into larger groupings.

The Ministry of Finance is continually upgrading China's accounting systems and standards in line with international practice, which is itself also being continually improved. Future tasks in this regard will include the elimination of existing inconsistencies between different standards and regulations.

6.3. Implications for the competitive environment

One of the main aims of China's WTO accession is to allow competition from increased imports and FDI to stimulate the competitiveness of domestic industry and thereby encourage the emergence of world-beating Chinese brands. There is no doubt that competition will intensify. In China there is a debate between those who espouse traditional infant-industry protectionist arguments and their opponents, who argue that in the long term domestic industry will benefit from competition with FIEs, the so-called strategy of "dancing with wolves".[21] Evidence from industries that have already been opened wide to foreign involvement, such as the white goods sector, strongly supports the latter.

A study conducted by the OECD in 2000 concluded that FDI had increased domestic competition in several industrial sectors where it had established a strong presence.[22] In these sectors, SOEs had been largely driven out but domestic collective and privately-owned enterprises were responsible for more than half of industrial production. The study found a positive correlation between SOE dominance in an industry and SOE pre-tax profit rates, suggesting that SOEs were largely reliant on a monopolistic situation for their profitability and tended to lose profitability when faced with competition. In those sectors where SOEs accounted for less than half of output, their profit margin was lower than that of FIEs and non-state Chinese firms.

The OECD study also showed that FIEs played a much more important part than imports in opening up the Chinese economy to "foreign" competition, since FIEs supplied a much higher proportion of the demand for industrial goods than imports for domestic use (as opposed to imports destined as production inputs or capital goods for export industries). The

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study found that in several sectors the relatively strong presence of FDI in the domestic market was associated with relatively high tariff protection. As such protection is removed as a result of China's 2001 accession to the WTO, competition from FIEs in such sectors will be supplemented or replaced by competition from imports.

It is not only Chinese firms that are concerned about the prospect of increased competition. In recent survey of foreign companies, including both actual and potential investors in China respondents, fears of increased competition from both other foreign investors, from private domestic companies, from imports and, to a lesser extent, from SOEs in China were voiced by a significant proportion of respondents.[23] A full 80 per cent of respondents from the Asia-Pacific region expressed concern over increased competition from foreign investors, suggesting that the traditional sources of foreign investment suspect that they may be partly displaced by more competitive FDI. These fears are actually a healthy phenomenon. They clearly demonstrate confidence in China's ability to fulfil its WTO commitments towards market opening. They also point to the likelihood that such opening will increase competitive pressures, allowing market forces to weed out inefficient foreign investors as well as inefficient domestic companies.

For this process to operate effectively, market opening needs to be accompanied by a business environment that facilitates competition. Such an environment is gradually emerging from the major institutional changes of the past two decades, which are not yet complete. In particular, SOE reform, which is an essential precondition for ensuring both banking system stability and healthy government finances, will, when completed, remove major obstacles to competition. The process of SOE reform itself offers opportunities for foreign investors to participate in industrial restructuring, helping to create more efficient enterprises, strengthen financial markets and offer employment opportunities to mitigate the negative employment effects of SOE reform.

For foreign investors to play a full part in SOE reform, the regulatory regime needs to be enhanced. The Chinese government is currently preparing legislation which will do this, reportedly including a competition law, an anti-monopoly law and a law on mergers and acquisitions (M&A). Once these laws have been promulgated, the role of foreign investors in the restructuring of SOEs will be clearer. Improvements in the regulation of capital markets, corporate governance, accounting standards, bankruptcy procedures and transparency throughout the corporate sector will help provide a stable foundation for such restructuring.

6.4. Cross-border mergers and acquisitions (M&A)

Global cross-border M&A flows have been increasing rapidly since the 1980s, growing at annual average rate of 26.4 per cent in 1986-90 and 23.3 per cent in 1991-95 before accelerating to 49.8 per cent a year in 1996-2000. They then fell back sharply – by 47.5 per cent – in 2001 as world economic growth slowed. Nevertheless, M&A flows remain a major form of FDI flow and M&A flows have since the mid-1990s become the main form of FDI flow between developed countries. However, cross-border M&A flows continue to play a very small part in China's FDI inflows, despite the rapid development of domestic M&A in China.

This is partly because there is no uniform legal structure within which M&A activity involving FIEs can take place. As a result, the M&A activity that does take place is constrained by piecemeal regulation, administrative rulings and advisory documents. This is hardly surprising, since such activity is a relatively new phenomenon in China; such laws have taken some time to evolve even in countries where cross-border M&A is commonplace. But the lack of a relatively complete legal framework has hitherto been a serious impediment to M&A and the Chinese government is now starting to put such a framework in place.

No FIE may acquire a domestically-owned enterprise if the latter is not in an industry designated as "encouraged" or "permitted" in the MOFCOM catalogues for guiding foreign investment. Even if the target firm is in the "encouraged" or "permitted" categories, a merger or acquisition by a foreign-owned enterprise may not be approved if it fails to meet the (often unpublished) criteria of local government departments in charge of specific industrial sectors. If it is in the "restricted" category, approval must be granted before acquisition is possible.

Takeovers of listed companies are covered by chapter IV of the 1998 Securities Law and by the Measures Concerning the Administration of Listed Company Takeovers issued by CSRC which came into effect on 1 December 2002. The 1998 law stipulate that an investor must notify the regulator, the target company and the public within three days of having acquired 5 per cent of a company's shares on the market, and that when an investor's holding reaches 30 per cent of a company's shares the investor must issue a takeover offer to all the shareholders. Listing and trading of the shares stops after the investor has acquired 75 per cent of the listed shares. Where the company no longer meets the conditions prescribed in company law, the enterprise form may be changed, which theoretically means that the diverse legislation on forms of business enterprise ownership should not prevent a FIE acquiring a domestically-owned enterprise. Interpretation of this law is in the hands of CSRC. The 2002 Measures cover the acquisition of shares of listed

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companies by agreement and by public offer as well as by stock exchange trading. They allow a takeover by public offer when the acquirer holds at least 30 per cent of the shares of the target company; the validity period of such an offer is 30-60 days.

In many countries, M&A activity occurs because of a global merger agreement involving multinational enterprises that have subsidiaries or other forms of local sub-enterprises there. In China this would take the form of the merger of two FIEs as a result of a global merger agreement between their parent companies outside China, or a FIE splitting into more than one enterprise as the result of a similar split in the parent company outside China. However, such operations are rare in China, where regulatory complexity reportedly results in China being "cut out" of such global agreements.

As is common practice elsewhere in the world, M&A may occur via the stock market. Foreign companies or FIEs may buy shares denominated in foreign currencies, such as B shares in Shanghai (denominated in US dollars) or Hong Kong (denominated in Hong Kong dollars), or in external markets such as Hong Kong or New York. Currently, foreigners may not buy A shares, which were originally intended for domestic buyers only, but in 2002 CSRC indicated that foreign investment would eventually be allowed in Chinese securities fund management firms, which can hold A shares, and that some qualifying foreign institutions would be allowed to buy A shares. It is not yet clear when the A-share market will be opened to foreign buyers. When it does, it will obviously be easier for a foreign company or a FIE to purchase a controlling stake in a listed company.

On 1 November 2002 CSRC, the Ministry of Finance and SETC jointly issued a Notice on Relevant Issues Concerning the Transfer to Foreign Investors of State-owned shares and Legal-person Shares of Listed Companies. The effect of this Notice is to allow foreign investors, as well as investors from Hong Kong (China), Macao (China) and Chinese Taipei, to buy unlisted shares of listed companies, which have hitherto been largely held by state-owned enterprises. (Such purchases had been explicitly prohibited in 1995.) Foreign investors wishing to buy unlisted shares must be of good standing and must acquire such shares by open bidding. Insofar as transactions involve state-owned shareholdings they are subject to examination and approval by the Ministry of Finance. Very large transactions (size unspecified) must be approved by the State Council. Foreign investors may not acquire shares in any industry in which foreign investment is prohibited and may not acquire control of any enterprise in any industry where enterprises must be under Chinese control.

Article 9 of the Notice stipulates that enterprises in which foreign investors acquire an interest by purchasing unlisted shares do not thereby

qualify for any incentives offered to FIEs. This stipulation appears to be designed merely to make explicit the effect of existing incentives rules. Tax exemptions and reductions are available only newly-established FIEs. CSRC rules do not allow newly-established enterprises to obtain listings, so even if a foreign investor were to acquire 100 per cent ownership of a Chinese listed company it would not qualify for all available FIE concessions.

All M&A activity, whether or not it involves a foreign investor, is regulated by a number of government organisations, each of which must be consulted before a particular merger or acquisition can be completed. Mergers and acquisitions involving state-owned enterprises or collective enterprises must be approved by the State Bureau of State-owned Property. Local industry and commerce bureaux are responsible for registering the business scope and registered capital of the new legal person entity and for deregistering the old legal person entity. Local tax bureaux have to decide on the continuation or otherwise of entitlement to favourable tax treatment and other taxation matters. It is up to the customs administrations to decide on the continuation or otherwise of entitlement to duty-free status on imported machinery and equipment of the old legal person entity by the new legal person entity. Local labour bureaux need to be consulted and informed about what happens to the workforce after a merger or acquisition takes place. After obtaining approval from relevant government departments, the entity acquiring a company must then obtain the consent of the target company itself, as well as its main stakeholders, including the workforce, creditors and bondholders, and major suppliers and customers, with whom formal agreements must be signed.

The role of cross-border M&A in assisting the process of SOE reform is explicitly recognised and welcomed in the Temporary Rules on Utilising Foreign Investment for the Restructuring of State-owned Enterprises, jointly issued by SETC, the Ministry of Finance, SAIC and SAFE on 8 November 2002. These rules expressly allow SOEs to be transformed in whole or in part into FIEs in various ways, including the acquisition of the SOE's assets, shares or bondholder rights by foreign investors. The selection criteria for foreign investors include management qualifications, level of technology, reputation, managerial ability, financial situation and economic power. As with other forms of cross-border M&A, project approval is limited by the catalogues for guiding foreign investment. Acquisition by a foreign investor can only take place after the workforce of the enterprise to be acquired have been consulted and only after agreement by those holding ownership rights – state representatives in the case of an SOE, shareholders and bondholders in the case of a listed company – have consented. Approval for foreign participation in SOEs may be granted by the economic and trade departments at the same level as the enterprise, unless the post-restructuring capital of the enterprise is $30 million or above, in which case the request must be submitted to the

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State Council, which is responsible for rejecting submissions considered likely to result in monopoly.

A major problem with current M&A procedures involving foreign investors is that they are unclear. At the national policy level, there is uncertainty over the precise nature of policy in this field, although quite clearly aimed at gradually facilitating more cross-border M&A activity as a stimulus to improvement in company performance. At local level, this uncertainty is manifested by a lack of clarity with regard to M&A procedures. In particular, it is not clear in all cases how many agencies must agree before approval is obtained. The addition of yet more powers of examination and approval has in this regard not been consistent with the government's programme of administrative reform.

Although M&As involving foreigners and FIEs are possible in principle, in practice they have so far been rare. A major factor in this regard is protectionism. Some government bodies and representatives of domestic industry maintain that foreign investors use M&A to establish foreign investor control of a sector, causing Chinese firms to lose control of it, so they oppose cross-border M&A activity and refuse assent if it is in their power to do so. Protectionism is also common at local level. This is largely because of taxation arrangements. When two or more enterprises situated in different local government jurisdictions merge, tax liability is no longer shared and must be concentrated in the headquarters of the merged enterprise. Local governments are therefore likely to withhold approval for any merger or acquisition which would result in such a loss of tax revenue.

Current practice is in several respects out of line with international norms. For example, the entire management of a company that is being acquired must agree before a company can be acquired. In other countries, many acquisitions take the form of hostile takeovers, in which the managers of the target company are generally against any change in control. It could be argued that the requirement to ensure prior management approval of a target company renders it impossible for efficient companies to acquire underperforming companies and turn them round.

7. Capital market opening

7.1. Capital account liberalisation lags behind current-account liberalisation

On 1 December 1996 China accepted the obligations of Article VIII of the Articles of Agreement of the IMF, by which it committed itself not to impose restrictions on the making of payments and transfers for current international transactions without IMF approval. As a result of Article VIII adherence, all enterprises, whether foreign-owned or domestic, may purchase foreign

exchange to make payments abroad for trade settlement, commissions, fees, royalties and dividends without the need for approval by SAFE.

In 1993 the Chinese government stated that it was moving gradually towards capital account liberalisation. However, when the Asian economic crisis of 1997-99 began with the devaluation of South-east Asian currencies China decided to refrain from letting the renminbi depreciate and also announced that it would maintain capital controls for the duration of the crisis. However, there is now no indication of a desire to relax capital controls in the near future.

7.2. Capital markets are not fully open to foreign investment

Controls on capital account include restrictions or prohibitions on foreign access to China's capital markets. The most important of these is that foreign investment in the Shanghai or Shenzhen stock markets is limited to B shares and foreigners may not lawfully buy A shares. The A share market is the predominant element on the two stock exchanges: for example, in 2001 the market value of A shares on the Shanghai stock market was CNY 2 693.5 billion, while that of B shares was only CNY 65.6 billion. The B share market, originally open only to foreign purchasers, was opened to domestic investors in February 2001, but has remained relatively small and illiquid.

The corporate bond market, which started operating in the 1980s, is strictly regulated in accordance with national financial planning and FIEs may not issue bonds on it.

FIE access to China's capital markets is limited. The stock exchanges have hitherto been almost the exclusive preserve of domestic enterprises and it is difficult for FIEs to obtain listings. A small number of multinational enterprises started to restructure themselves in preparation for listing after it was announced in November 2001 that FIE listings would be permitted following China's accession to the WTO. Current plans indicate that a dozen or so FIEs will become listed in the next few years, compared to nearly 1 200 domestic enterprises listed at present. FIEs are not yet able to raise money via corporate bond issues. Access to venture capital is limited, and investment by venture capital funds is discouraged by the lack of a liquid stock market in which to effect an exit strategy.

A major form of FDI in OECD countries is the acquisition of a lasting interest in an overseas company by means of equity participation. The OECD benchmark definition of FDI includes the acquisition of 10 per cent or more of the ordinary shares or voting stock of an incorporated enterprise, as well as the acquisition of a similar interest in an unincorporated enterprise.[24] Such

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portfolio FDI inflows are relatively scarce in China because of obstacles to foreign participation in the stock markets.

Portfolio FDI inflows are restricted by the largely closed nature of China's capital markets. At the same time, the expansion of FIEs is limited by restrictions on capital-raising measures such as corporate bond issuance. Steps towards allowing portfolio inflows to play a more effective role in enhancing inward FDI would include allowing more FIEs to list on domestic stock markets and opening the A share and bond markets to full foreign participation.

ANNEX 1

Elements of a Broader Enabling Environment

1. Development of the rule of law in China

Laws relating to FDI have, especially since the early 1990s, become increasingly precise and focused. Codes of law tended in the past to be brief and vague, allowing maximum room for interpretation by officials. The rationale for this practice was that officials should not be restricted by inflexible rules when dealing with concrete local situations, but should be able to judge according to specific circumstances. The system has therefore generally been weighted in favour of maximum flexibility. During the reform period, however, national leaders have postulated an overall goal of moving from the "rule of man" to the "rule of law" which, if it is to be achieved, will necessitate more precise framing of legislation and more consistent and transparent implementation and enforcement.

A major feature of the reform process since 1978 has been the devolution of policy application and legal enforcement to local level. This has enabled enforcement to become more thorough than if it had remained dependent on central initiatives, and it has also allowed more adaptation to local conditions–a consideration that has traditionally been considered important in China. On the other hand, localised enforcement can be less consistent than national, and it is also more likely to be subject to pressure from local officials to conform to local vested interests. Since 1985, the central government has attempted to ensure more regular application of national policies and regulations at local level by introducing an element of accountability to the local population in the form of a system of local elections.

A larger body of qualified legal personnel should, in principle, be better able to resist pressures from outside the legal system, but they will only be able to do so if the political system embodies respect for the principle of judicial independence. A crucial test of judicial independence is the existence or non-existence of judicial review of government action. If a court may rule a

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government action illegal, overturn it, and enforce that action, such a judgment demonstrates strong judicial independence. China's legal system was not until recently characterised by such independence, but regulations are now in place which do provide the possibility of judicial review of official decisions. It is of particular importance following WTO accession that judicial independence by strengthened and that administrative review become entrenched, because the protocol of accession explicitly stipulates that China must establish independent, disinterested tribunals and procedures for prompt review of all administrative actions relating to implementation.

All China's economic legislation has been created since 1978 on the basis of foreign models. It has not been developed incrementally to meet specific needs but has been imported wholesale and imposed on a society to which the concepts on which it is based are alien to both historical traditions and both individual socialisation. In many respects it is like a transplant or graft that is in danger of being rejected by the many natural antibodies it encounters.

Since economic and business laws have only been formulated very recently, and are based on foreign models, they have not had time to become established in the minds of the population. The government has therefore spent resources on education designed to familiarise the public with these new laws. Official press reports make it clear that such efforts have not yet prevented large numbers of people from engaging in frequent and flagrant abuses of the law. However, there are signs of increasing use by ordinary citizens to obtain redress. As more and more people experience the courts first hand as an effective means of securing justice, the laws involved, and law in general, will begin to take root and become more accepted by the public.

Although laws are passed by the NPC, the country's legislature, the similarity to legislative processes in other countries is merely formal, as it is not usual for the NPC to reject any legislation placed before it. Laws originate from numerous specialised government bodies charged with formulating them and are then delivered for passage to the NPC, or its Standing Committee if it is not in session, and subsequent promulgation. Legislation is a secretive process, with discussion and debate typically taking place within ministries without public participation, although there have been some notable exceptions to this closed procedure. Where consultation does take place, it is at the behest of the officials in charge of drawing up the law; those consulted have no automatic right to make representations on their behalf, even if they belong to a constituency directly affected by a new law.

FIEs are occasionally invited to participate in consultations when a law is being drafted, but they are sometimes consulted without seeing or without being able to review at leisure a written draft of the law or regulation. Government officials say that a major criterion used to decide which

companies to invite is whether or not the company has a dominant position in a particular market or industry. However, some FIEs complain of having been left out off the list while, they allege, other companies with a lesser claim have been asked to attend and proffer advice. The consultation process is inevitably incomplete, falling far short of the free discussion in the electronic and print media normal in many OECD countries. Consequently, a company taking part in a closed consultation session is likely to feel that it has been granted a special privilege denied to those not invited; if the session is open, it may decide not to make too many of its comments public and its advice is therefore likely to be of less practical use. The Chinese authorities state that they do not consider that only a few foreign-invested enterprises are invited to participate in the process of formulating laws.

Because laws are not freely discussed by a wide range of stakeholders before promulgation, they frequently contain elements that are incomplete, inappropriate or inaccurate. After these imperfections have been drawn to the government's attention, a set of implementing regulations is drafted to fill the gaps, elaborate the details and rectify blatant errors. Until the implementing regulations are published it is often difficult to apply the original law because its detailed terms remain uncertain. Publication is not automatic; implementing rules are often circulated internally for some time, so that they are not available to the public. Advance publication would increase transparency regarding legislation and would also have the effect of forcing officials to explain the specific public purposes intended to be served by laws and regulations.

A large number of foreign law firms set up representative offices in China in anticipation of the opening up of the legal sector to foreign participation following WTO accession. Between 1992 and August 2002, the Ministry of Justice approved the establishment of 109 foreign law offices and offices of 28 Hong Kong law firms in 11 Chinese cities, largely in Shanghai and Beijing. The "one firm, one office" rule that limited foreign law firms to a single office in China was lifted in 2000, permitting foreign law firms to service clients who have business operations in several cities. By end-2001, 20 foreign law firms had submitted applications to open second branches in China.

However, foreign law firms still report a number of difficulties in both establishment and operation. Some foreign law firms, including law firms based in Hong Kong (China), that they have had to wait up to five years before being granted a licence to operate on the Chinese mainland. The lifting of restrictions on the location and number of foreign law firms which China has agreed to implement, and which was implemented in regulations promulgated in January 2002,[25] appears to be heavily qualified by regulations that took effect in September 2002[26] that give the Ministry of Justice the right to decide whether to allow the opening of new offices on grounds of local

social, economic and legal-services development. Foreign law firms may not hire locally qualified lawyers and may not invest in local law firms. Since lawyers qualified in other legal jurisdictions may not practice Chinese law, this limits the services foreign law firms may offer their clients. The September 2002 regulations further restrict the activities of foreign law firms by prohibiting them from dealing directly with any Chinese government department and from acting on behalf of foreign companies in arbitration cases. Multinational enterprises often prefer to use a single law firm in order to co-ordinate their operations effectively round the world. At the same time, Chinese firms investing or trading abroad have a harder time obtaining foreign legal expertise.

Current efforts to improve the functioning and independence of the legal system could be intensified by such measures as training and appointing legally-qualified judges to all courts; raising the pay of judges and other key legal personnel to reduce their vulnerability to offers of bribery; enhancing the status of judges *vis-à-vis* local government and party officials; and establishing at national and regional level mechanisms to guarantee the execution of court judgments.

Current efforts to establish a more transparent and accountable process of formulating legislation and regulations could be expanded. All legislation and regulations could be published on a single, comprehensive, up-to-date and easily-navigable web site in both Chinese and English. A mechanism similar to that of the US Federal Register or equivalent systems in other OECD countries may be introduced to publish draft laws and regulations and obtain public feedback on them as early as possible before promulgation. The scope of stakeholder consultation with regard to FDI-related legislation could be expanded and regularised.

2. Legal recourses[27]

The Chinese legal system contains an element of conciliation that is not present in many other jurisdictions. Although litigation is becoming more common in Chinese society, usage of such conciliation procedures remains popular, since it offers a quicker, cheaper and less vituperative method of dispute resolution. Local mediation committees handled over 5 million civil disputes in 2000. A more specific conciliation procedure is available for disputes relating to the economy, trade, finance, security, investment, intellectual property, technology transfer, real estate, construction contracts, transport, insurance and other commercial and maritime business. In 1987 the China Council for the Promotion of International Trade (CCPIT) and the China Chamber of International Commerce (CCOIC) set up the CCPIT Conciliation Centre in Beijing for this purpose and in the 1990s this was

expanded to form a national network of over 30 conciliation centres. Such centres are not restricted to cases involving foreign investors or enterprises. Cases are accepted by the centres in accordance with a conciliation agreement between the parties, or, in the absence of such an agreement, on application by one party with the consent of the other party. Cases taken to the conciliation centres are expected to reach "an amicable settlement agreement" by the free will of both parties.[28] The number of cases referred to the centres has not been great (some 2,000 by the end of 1999), presumably because disputes that are capable of easy resolution can be handled without recourse to outside conciliation, but the CCPIT states that the success rate is about 80 per cent. The CCPIT Conciliation Centre has signed co-operation agreements with similar centres outside China, including the Hamburg and New York centres. In 1995 it joined the International Federation of Commercial Arbitration Institutions (IFCAL) and in 1997 it joined the London Court of International Arbitration.

When foreign partners in Sino-foreign joint ventures find themselves in disagreement with their Chinese partners over such matters as the interpretation of the provisions of a joint venture agreement, contract or articles of association, they are first expected to resolve the dispute through consultation or mediation, for example via a conciliation centre. If this fails, there are several avenues for dispute resolution, including arbitration within China, arbitration abroad and litigation within China. Litigation is increasingly being used, but arbitration remains the preferred option, especially as enforcement of court judgments is largely left to the public security bureaux, who do not regard it as their top priority. The Chinese authorities do not share the view that public security organs are the executors of court judgments. A dispute may be taken to the China International Economic and Trade Arbitration Commission (CIETAC) or, if appropriate, to the Chinese Maritime Arbitration Commission (CMAC). The CIETAC has its headquarters in Beijing and also has branches in Shanghai and Shenzhen and is reportedly the busiest such centre in the world. Other large cities also have their own arbitration centres which can handle disputes involving foreign partners as well as purely domestic disputes. CIETAC handles:

- International or "foreign-related" disputes.
- Disputes relating to Hong Kong (China), Macao (China) and Chinese Taipei.
- Disputes between FIEs or between an FDI and a Chinese legal person.
- Disputes arising from project financing, invitations to tender and bidding submissions, project construction and other activities conducted by a Chinese legal person and other persons or economic organisations that use capital, technology or services from foreign countries, international organisations, or from Hong Kong (China), Macao (China) or Chinese Taipei.

- Any other disputes that the parties have agreed to arbitrate by CIETAC.[29]

Disputes are accepted on the written application of one of the parties to the dispute in accordance with the arbitration clause in the contract or other written agreement signed between the parties and are handled by arbitration panels selected by CIETAC from among Chinese and foreign persons with professional knowledge and experience in various fields. The tribunal must render an arbitral award within nine months from the date of formation of the tribunal. Arbitration tribunals are empowered to combine conciliation with arbitration. This means that an arbitration tribunal may, with the consent of both parties, help the parties to reach a voluntary amicable agreement and make a consent arbitral award, saving time and expense that would otherwise usually be necessary for an ordinary arbitral award. As would be expected from the more complex procedures involved in arbitration as compared with those of conciliation, CIETAC fees are slightly higher than those charged by the CCPIT Conciliation Centre. For example, for disputes relating to claims of between CNY 10 million and CNY 50 million, CIETAC charges CNY 210,000 plus one per cent of the amount above CNY 10 million while the Conciliation Centre charges between 0.5 per cent and 0.75 per cent of the claimed amount.[30] With the mutual consent of the parties concerned, arbitration can also be carried out through an arbitration agency in the country where the sued party is located or through one in a third country. The availability of an enforceable arbitration procedure outside China allows foreign investors to avoid the current shortcomings of the legal system in China in many cases. China has been a member of the International Centre for the Settlement of Investment Disputes (ICSID), so that arbitral awards by the ICSID in disputes involving China and the 135 other contracting states can be enforced under the terms of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which China joined in 1987 (for commercial disputes only).

The option of taking arbitration to centres outside China has been taken by many foreign joint-venture partners in recent years. The main centres involved are the Stockholm Chamber of Commerce, the London Court of International Arbitration, the International Court of Arbitration of the International Chamber of Commerce and the Hong Kong International Arbitration Centre. Bilateral treaties signed by China with many countries include detailed provisions for the formation of arbitration tribunals chaired by a third-country national to make binding judgments regarding unresolved disputes between nationals of the two countries concerned. Such mechanisms are an important addition to domestic dispute resolution procedures because they remove any element of bias perceived to exist in the domestic court system of either country. It should be borne in mind that enforcement of an international arbitral award in China is still the function of

Chinese courts and is not automatic, as it is possible for a Chinese court to challenge the status of such an award and cases in which awards have been overturned on such grounds have occurred.

In addition, local centres established under such bodies as municipal service centres for foreign investment and municipal foreign economic and trade committees deal with complaints against government departments and suggestions for improving the FDI environment. These appear to be becoming more systematic. For example, in March 2001 a set of measures for handling FIE complaints was promulgated in Beijing designating the Beijing Centre for Handling Complaints Lodged by Foreign-Funded Enterprises within the Beijing foreign investment service centre. Under this system, local governments down to county level are charged with setting up centres to handle complaints from FIEs and report them to the municipal centre within three days of receiving them. The municipal centre must then reply to all questions that it can answer within three days and transfer those that it cannot answer to the handling department within three days and inform the complainant of the transfer. The handling department must then contact the department being complained about to verify the related information and inform the complainant of the result within 15 days.[31]

3. Intellectual property protection

The need for legislation to protect intellectual property rights was recognised in the late 1970s, when the Chinese government realised that without such protection it would be difficult to attract foreign investment embodying new technology. It was also realised that legal recognition of patent rights was necessary to stimulate and nurture indigenous inventiveness; this perception was supported by the return to the use of material incentives in the economy after a long period during which these had been disallowed.

The Chinese government initiated co-operative links with other countries in step with its promulgation of specific intellectual property rights protection legislation. On 3 June 1980 China became a member of the World Intellectual Property Organisation (WIPO). Just over two years later, on 23 August 1982, the Standing Committee of the NPC passed the Trademark Law of the People's Republic of China, which came into effect on 1 March 1983. This was followed by a Patent Law, effective from 1 April 1985. On 19 March 1985 China became a member of the Paris Convention for the Protection of Industrial Property.

However, these measures were initially incomplete because they lacked an effective foundation in civil law. This problem was rectified in April 1986, when the NPC passed the General Principles of the Civil Law of the People's Republic of China, which came into effect on 1 January 1987. This new civil law

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code contained the first explicit definition of intellectual property rights as the civil rights of citizens and of legal persons, and the first affirmation of the rights of authorship/copyright as rights of citizens and legal persons.

During the following six years, China entered into a number of international agreements to strengthen the protection of intellectual property rights. In 1989 China was one of the first countries to sign the Treaty on Intellectual Property in Respect of Integrated Circuits adopted by WIPO. In October of the same year China also became a member state of the Madrid Agreement for the International Registration of Trademarks under WIPO auspices. On 15 October 1992 China was accepted by WIPO as a member of the Berne Convention for the Protection of Literary and Artistic Works and on 30 October 1992 China became a member of the UNESCO Universal Copyright Convention. On 30 April 1993 China became a member of the WIPO Convention for the Protection of Producers of Phonograms Against Unauthorised Duplication of Their Phonograms. China also became a member of the WIPO Patent Co-operation Treaty on 1 January 1994.

In the early 1990s China continued to fill gaps in its domestic IPR legislation. A Copyright Law, passed by the NPC Standing Committee in September 1990 went into effect on 1 June 1991. This was supplemented soon after by Regulations on the Protection of Computer Software, effective from October 1991, and by Regulations on the Implementation of the International Copyright Treaty, effective from 25 September 1992, which specifically protects the rights of foreign authors. On 1 December 1993 the Law of the People's Republic of China on Combating Unfair Competition went into effect. Basic IPR laws passed in the 1980s, notably those on trademarks and patents, were also refined and expanded.

The Trademark Law and its implementing rules were revised in 1993 to expand the range of trademarks protected to include services trademarks as well as commodity trademarks in line with the requirements of the GATT Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS). In February 1993, the NPC Standing Committee adopted the Supplementary Regulations on Punishing Criminal Counterfeiting of Registered Trademarks. A second revision took place in September 2001.

In September 1992 the Patent Law was revised. The new law expanded the scope of patent protection to all types of technological inventions, whether new products or new techniques, including pharmaceutical products and substances obtained by means of a chemical process, foods, beverages and flavourings. The duration of an invention patent was lengthened from 15 to 20 years from the date of application. In addition to extending the protection of a patented process to include products directly produced by that process, the new law stipulated that the importation of patented products

requires the explicit permission of the patent holder. The Patent Law was revised again in August 2000.

In addition, the Supreme People's Court has made a number of important interpretations which have further refined and strengthened IPR legislation, especially in areas where existing law does not cover new technology. For example, in December 2000 the Court ruled that works protected by the Copyright Law included digital forms of protected works and in July 2001 the Court set out rules governing the elements that must be proved to show that the registration and use of a computer network domain name constitutes infringement or unfair competition.

The government has endeavoured to educate the population in the formerly unfamiliar concept of intellectual property rights by a variety of means. It has also devoted resources to training a large number of officials responsible for implementing IPR laws in co-operation with WIPO and other international organisations.

According to Article 1 paragraph 3 of the TRIPS Agreement, WTO members must accord the treatment provided for in the TRIPS Agreement to the nationals of other WTO members; Article 3 paragraph 1 further states that each member shall accord to the nationals of other members treatment no less favourable that that it accords to its own members with regard to the protection of intellectual property. There is no requirement to extend this treatment to non-WTO-member nationals. However, since the majority of economies are already WTO members and some of the remainder may accede to the WTO during the period of operation of current legislation, compliance with this requirement can be ensured by providing a wholly non-discriminatory framework of IPR protection legislation, which China has done. In addition to providing protection guaranteed by bilateral treaties, Chinese laws explicitly stipulate that all FIEs enjoy the same rights as domestic companies and individuals with regard to trademarks and patents.

One indicator that should be considered is the number of patent applications filed. Inventors and innovators who consider that patent protection is not effective are less likely to file such applications, so if the number of applications is increasing, it is reasonable to suppose that the public places some trust in patent protection. The number of patent applications has risen sharply in recent years, suggesting increasing confidence in the system, and also indicating why there has been no discernible movement against IPR protection legislation in China as there has been in other developing countries where a large section of the population, for example the farming community, fears the effect of foreign patents on existing indigenous technology. Many Chinese are just as interested in protecting their inventions as are foreign companies, judging from the fact

that a majority of patent applications have been domestic. Confidence by foreign patent applicants in the system is also indicated by the large number of foreign applications examined in 2000, the majority of them from OECD countries.

An increasing number of cases involving intellectual property have come before the courts in China in recent years. To solve the problem of lack of specialised knowledge in the ordinary courts, China has established a number of courts that deal exclusively with IPR dispute resolution. The first IPR court was established in Beijing in 1993. By late 2001 these courts had heard 59 overseas-related IPR cases. Where IPR infringement has been confirmed, the sums awarded to foreign companies have tended to be smaller than those demanded. However, it is not unusual for such settlements to vary widely in magnitude between countries, especially developed countries like Japan and the US and developing countries. Prominent media coverage has been given to campaigns to stamp out practices such as copyright pirating and producing counterfeit goods. Television news coverage has frequently been given to the confiscation and destruction of items such as fake CDs.

Foreign investors continue to raise concerns about instances of intellectual property rights violations which are not always dealt with effectively by the courts. The main task ahead is to improve enforcement of existing laws on a regular rather than a sporadic basis and at the same time develop a public culture which respects intellectual property rights at all levels of society and the economy. Doing so will benefit domestic companies and individuals by protecting their trademarks, copyright and patents, and will also help attract more high-quality FDI to China. As one author puts it: "China cannot realistically hope to attract foreign direct investment, secure transfers of cutting-edge foreign technology, or foster world-class research and development if foreign firms are not convinced their IPR will be adequately protected".[32]

While maximum penalties and damages are specified in the patent, trademark and copyright laws, there are no minima. The deterrent effect of the law is therefore not inherent in the law itself, but in the stringency with which it is applied, which may vary with time and place. It is also unclear how serious a violation of IPR must be before it can be brought to court. The laws do not explain clearly the procedure for taking IPR cases to the courts. Although a framework of IPR legislation in accordance with WIPO standards has been constructed, examples of IPR violations are still clearly visible in cities all over China. The existence of at least one large wholesale market which engages mainly in the distribution of copies of products of well-known global brands indicates that some local governments have not yet managed to deal with the problem. The government is itself unable to prevent counterfeiting of products produced by government monopolies, such as the

tobacco industry, which lose large sums of money each year from lost sales. The Chinese government's inability to protect itself against counterfeit manufacturers raises doubts about its ability to protect the intellectual property rights of foreign investors.

A further problem is that the sale of copies is not restricted to China. Counterfeit products are being exported from China to both developed OECD countries and to emerging markets, in large quantities. The consumer of such products suffers both from a lack of quality control and of after-sales service. A serious danger is that these insufficiencies will lead to product liability disputes when they cause actual physical harm to purchasers or to third parties. Examples have already occurred of Chinese producers of food products suffering lost sales because of reports of health risks from copies of their products made in China and sold abroad.

Despite education campaigns, there is insufficient public respect for IPR. As Zhou Lin, deputy director of the Centre for Intellectual Property under the Chinese Academy of Social Sciences, put it: "Many people have little idea that intellectual property rights are just like a TV, a VCD and a house, that they are owned by somebody, and, if you want to use them, you should ask the owner first."[33] Although no sales figures are available, there is no doubt that many businesses and individuals regularly purchase counterfeit software, undermining sales of the genuine article. One indication of this is the very low ratio of sales of computer software to sales of computer hardware, which in other countries is usually near 1:1. The widespread purchase and open use of unlawful products at all levels of society bespeaks a public tolerance of IPR violation that makes successful prosecution of infringement difficult. The practice of forging qualifications is widespread: the 2000 population census recorded over 600 000 more higher education certificates than had actually been awarded. These cases are of crucial importance to foreign investors who wish to hire skilled personnel and need to be able to trust documentary evidence of educational qualifications.

While confidence in the patent application process appears to be strong, judging by the number of applications, concerns are frequently heard about the length of time taken before an application is examined and granted (or refused). This complaint is partly borne out by the magnitude of the discrepancy between the number of applications filed and the number granted. For example, in 2000, 170 682 applications were filed, while only 105 345 were granted. To some extent this discrepancy is explained by the 18-month time lag and by the rapid increase in applications, but this is not a complete explanation, as there were already 134 239 applications in 1999.[34]

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4. Corruption

As in other transition and developing economies, corruption has been described by various commentators, including the country's leaders, as constituting a serious problem in China. It is intrinsically immeasurable because corrupt activities are illegal and therefore hidden. The only statistics available are those on investigation and punishment, which, as with all crime figures, omit by definition all undetected offences. In 2000, procurators' offices in China investigated 104 427 cases of alleged offences by public officials.[35] Of these, 20 966 involved abuse of power, dereliction of duty and fraudulent practices, while the majority, 83 461 cases, were listed as "corruption and bribery". The latter category was further broken down into 44 874 cases of corruption, 20 771 cases of bribery, 14 958 cases of misappropriation of public funds, 901 cases of illegal possession of public funds, 281 cases of unstated source of large properties and 1 676 other cases.

Published figures indicate that the size of bribes and amounts of state property embezzled have increased. For example, a fraud involving hundreds of officials in Guangdong province who had used fake export certificates to claim tax rebates that was unearthed in 2001 was reported to have run into billions of dollars. Similar sums, amounting to a significant proportion of government revenue, have been reported missing from state funds in recent years. However, it is widely believed that even these figures greatly understate the true extent of corruption. Corruption reported by foreign investors also understates the problem because the multinationals may be subject to prosecution in the countries in which they are based for corrupt payments made in China, according to the 1997 OECD Convention Against Bribery in International Commercial Transactions.

The movement from a centrally-planned to a market economy has generated many rent-seeking opportunities for officials. For example, the dual-track pricing system that was introduced in 1985 generated rents estimated by one group of Chinese experts as being equivalent in 1988 to between 10 and 20 per cent of GDP.[36] This is not a new phenomenon: in another report, the same writer, using firm-level data, estimates that corruption proceeds were already 8 per cent of GDP in 1980.[37] This particular form of corruption must have decreased as the dual-track pricing system was phased out in the 1990s. It cannot survive, as dual pricing is not allowed under WTO rules.

However, there are still situations in which uncertainty and ambiguity generate opportunities for corruption. Despite much tightening up in recent years, laws and regulations still tend to lack specificity and are therefore subject to interpretation by those responsible for implementing them. They may also on occasion be inconsistent with each other, forcing the authorities to choose which to enforce.

Another area of uncertainty relates to registration, licensing procedures and technical controls such as auditing or inspection. Registration procedures remain complex and sometimes lengthy. One way to speed up the process is to give bribes (sometimes known as "facilitation payments"). Although technical controls are officially motivated by the interest of verifying that an investment project complies with all business-related laws, they may often lack transparency and leave considerable room for administrative discretion in inspecting or auditing an investment. Foreign investors have complained of deliberate disruption of production schedules by spurious inspections forced on them by agencies of whose existence they have not previously heard; such agencies allegedly request payment in exchange for their departure.

The monopoly power of officials renders them vulnerable to offers of monetary or other rewards for "special treatment" and also provides them with opportunities to make such offers of special treatment. A major reason for the existence of corruption is the disparity between low salaries and strong powers. This combination of a high level of discretion, monopoly of administrative power and low pay is typical of the settings in which corruption flourishes worldwide. It can be dealt with by tackling each element in the situation, that is, by raising salaries, eliminating ambiguity from the regulations and reducing the decision-making powers of officials.

Corruption is also involved in the problems that beset the legal system. Government and communist party officials have been known to interfere in the making and enforcing of court decisions, and the financial and social status of judges can conceivably render it difficult for them to maintain total independence. Nor are local public security bureaux always assiduous in enforcing court decisions in favour of foreign investors when these conflict with local vested interests. The Chinese authorities have stated that public security organs do not enforce court judgments.

Corruption has altered in form as economic institutions have evolved. In the early part of the reform period, when there was a chronic shortage of consumer goods, officials could use their privileged access to goods, employment and promotion opportunities and other in-kind benefits to obtain other scarce items. The dual-track pricing system encouraged the monetisation of corruption, especially since bank accounts containing corrupt payments could be held anonymously. This loophole was closed when, in 2000, the government required depositors to use their real names when making deposits and prepared to link computer systems of all banks to enable the authorities to identify all deposits made by a single individual. Another form of corruption is the use of loans to SOEs for investment in stocks or real estate, with officials keeping any profits and leaving the banks to bear losses.

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The form taken by corruption involving foreign investors and government officials may vary. Direct cash payments occur, but other, more subtle, methods are reportedly also used. A local official who has been co-operative in achieving some desired goal of the FIE may be rewarded with a consultancy contract. The child of another high-level local official who has helped ensure project approval may be awarded a scholarship to attend an educational institution in the foreign investor's home country.

Corruption can be a deterrent to FDI because it imposes a cost on the FIE for which there is no corresponding benefit. It is sometimes argued that corrupt practices such as bribing officials to circumvent unnecessarily lengthy bureaucratic procedures can produce an efficiency gain and therefore increase the overall volume of goods and services available. Two commentators on corruption in China even suggest (not very persuasively, since they adduce no evidence) that it also provides an effective inducement to local officials to promote economic reform.[38] However, the damage done to trust in official institutions by the existence of systematic corruption and the higher cost suffered by honest companies that refuse to pay such bribes should also be taken into account.

There is an extensive and growing exposure of OECD-based enterprises and their foreign subsidiaries to the sensitive Chinese business environment. It is clear that the volume of FDI, which includes a large number of government contracts (government procurement and construction projects are among the sectors most afflicted by corruption), entails the exposure of OECD companies and their subsidiaries to corrupt practices and the solicitation of bribes.

It should be borne in mind that trials of public officials on serious bribery charges are not always conducted in public and that therefore the identity of bribers is not always clear; in a few cases, it is conceivable that the bribes received by such officials emanated from external sources. It is therefore not possible to provide a categorical affirmation that no project approval has ever been granted as a result of corrupt payment.

The existence of systematic corruption in the Chinese economy affects FIEs even when they do not appear to be directly involved. For example, even if an FIE is not approached for bribes, it may encounter problems that result from the payment of bribes by domestically-owned competitor companies if those companies benefit from favours from bribed officials. In the next few years, FIEs are likely to be increasingly involved with domestic companies as M&A starts to play a larger role in FDI in China. They will therefore have to cope with any corruption that may occur such companies as well as any corrupt practices indulged in by competing FIEs.

OECD-based enterprises are accustomed to operating in a legal and administrative framework that eschews corruption. Adapting to a business environment characterised by systematic corruption involves a cost to multinationals, whether this is in the form of corrupt payments actually made or in the form of revenue lost by refusing to make such payments.

It is sometimes suggested that it is difficult for an executive to separate corrupt from non-corrupt patterns of behaviour when attempting to adapt to a genuinely different cultural environment, entailing confusion about the correct behaviour to engage in. For example, gift-giving is a deeply embedded part of Chinese culture, so it is difficult to refuse all gifts from actual or potential business partners or, on the other hand, to refrain from giving gifts to them.

However, it is quite possible to work within the confines of a gift-giving culture without indulging in corrupt behaviour, as there is nothing inherently corrupt in the practice of making gifts. Such gifts are only corrupt if they lead to the granting of an advantage which would otherwise have been withheld.

China has made some progress in tackling corruption and has also made a positive contribution to the ADB-OECD Anti-Corruption Initiative for Asia-Pacific. Further progress will be greatly enhanced by implementing the recommendations of this report regarding increased transparency and rule of law, in particular reducing regulatory ambiguity and the scope of official discretion, and raising the pay of state officials. Further progress will also be supported by deepening the co-operation between China and the OECD in dealing with corruption issues.

Notes

1. OECD (2003), *OECD Investment Policy Reviews, China: Progress and Reform Challenges*.
2. The statistics used in this paper are the official annual FDI statistics provided by the Ministry of Commerce (MOFCOM, formerly the Ministry of Foreign Trade and Economic Co-operation, MOFTEC) of the People's Republic of China. These statistics are the most complete set available. However, they are not based on internationally recognised standards that are generally applied to OECD countries and it should be borne in mind that there are serious inconsistencies between these statistics and the statistics compiled by OECD countries on their investment in China.
3. National Bureau of Statistics, China Statistical Abstract *[zhongguo tongji zhaiyao]* 2002.
4. Chen Chunlai, *Provincial Distribution of Foreign Direct Investment in China,* Research Paper to the MOFTEC/OECD co-operation programme on FDI, cited in OECD (2002), *China in the World Economy: The Domestic Policy Challenges*, *Foreign Direct Investment: Prospects and Policies*, p. 339. The variables used in the econometric study include: market size (GDP), per capita GDP, GDP growth rate, efficiency wage, labour quality, accumulated FDI stock, economic distance and trade and investment régime.

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5. It is important to bear in mind that FDI from Hong Kong (China) includes components such as investment from the Overseas Chinese diaspora and "round-tripping" investment from China itself (routed via Hong Kong (China) to take advantage of FDI incentives such as tax reductions) which are inherently difficult to measure. Back in 1992, according to one estimate, 13 per cent of China's total FDI intake stemmed from round-tripping; a contemporary World Bank estimate put the 1992 figure at 25 per cent. Opinions differ as to whether the practice has grown or diminished since then.
6. Official Chinese government statistical sources distinguish between "contracted" and "realised" (also translated as "utilised" or "actually utilised") FDI. The former represents commitments, the latter funds drawn down.
7. Calculated from OECD (2002), *International Investment Perspectives,* Vol. 1, p.30.
8. According to Chinese customs statistics, which are considered by the United States government to understate this statistic, mainly because it excludes imports to the United States from China via Hong Kong (China).
9. "Province" is used in this study to denote all provincial-level administrative units, including the 23 provinces, the five autonomous regions (Guangxi, Inner Mongolia, Ningxia, Tibet and Xinjiang) and the four cities directly responsible to the State Council (Beijing, Chongqing, Shanghai and Tianjin). The two special administrative regions of Hong Kong (China) and Macao (China) which became part of China in 1997 and 1999 respectively, have their own separate statistical systems and are not included in China's national statistics. Chinese Taipei is not usually included in China's national statistics.
10. OECD (2002), *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*.
11. The accession documents are available on the WTO web site *www.wto.org*.
12. Both Chinese and English language versions of the three published catalogues are included in MOFTEC (2002), *China Investment Guide*.
13. *Guoji Jinrong Bao [International Finance],* 12 June 2002.
14. OECD (2001), *Corporate Tax Incentives for Foreign Direct Investment, OECD Tax Policy Studies No. 4*.
15. Liu, Xiaohui and Wei, Yingqi (2002), *Export Requirements and Special Features of Inward Foreign Direct Investment in China*.
16. Deloitte, Touche, Tohmatsu (2002), *Foreign Investment into China: Fitness Survey*.
17. The SETC was abolished and its functions and staff incorporated into the new Ministry of Commerce in the March 2003 government reorganisation.
18. Tenev, Stoyan and Zhang, Chunlin (2002), *Corporate Governance and Enterprise Reform in China,* World Bank and International Finance Corporation, Washington DC.
19. OECD (2002), *China in the World Economy: The Domestic Policy Challenges*, *Establishing Effective Governance for China's Enterprises*, page 443.
20. Chen, Chien-Hsun and Shih, Hui-Tzu (2001), *Initial Public Offering and Corporate Governance in China's Transitional Economy*, Chung-Hua Institution for Economic Research, Chinese Taipei.
21. Yan, Xu and Kan, Kaili (2000), *Dancing with Wolves: Is [sic] Chinese Telecommunications Ready for the WTO?* Paper given at the International Telecommunications Society 2000 Conference, Buenos Aires.

22. OECD (2000), *Reforming China's Enterprises*.
23. Deloitte, Touche, Tohmatsu *(op. cit.)*.
24. OECD (1999), OECD *Benchmark Definition of Foreign Direct Investment*.
25. Regulations on Representative Offices of Foreign Law Firms in China, promulgated by the State Council as its Order No. 338 on 22 December 2001 and put into force on 1 January 2002.
26. Stipulations of the Ministry of Justice Concerning the Enforcement of the "Regulations on the Management of Representative Offices set up by Foreign Law Firms in China", Order No.73 By the Ministry of Justice of the People's Republic of China.
27. China has a four-level court system. The Supreme People's Court, which is the highest judicial organ, responsible to the NPC, or, when the NPC is not in session, to the NPC Standing Committee, sits in Beijing. Higher People's Courts sit in the provinces, autonomous regions and municipalities directly under the State Council, such as Shanghai. Intermediate People's Courts sit at the prefecture level and also in parts of provinces, autonomous regions, and municipalities directly under the State Council. There are also basic People's Courts in counties, towns, and municipal districts. Special courts handle matters affecting military, railroad transportation, water transportation, and forestry. The court system is paralleled by a hierarchy of prosecuting organs called People's Procuratorates; at the apex of this structure stands the Supreme People's Procuratorate.
28. China Council for the Promotion of International Trade (CCPIT) and China Chamber of International Commerce (CCOIC) Conciliation Rules (2000).
29. China International Economic and Trade Arbitration Commission (CIETAC) Arbitration Rules, revised and adopted by the China Council for the Promotion of International Trade and the China Chamber of International Commerce on 5 September 2000, effective from 1 October 2000.
30. CIETAC Arbitration Fee Schedule and CCPIT/CCOIC Conciliation Fee Schedule.
31. Measures Governing the Handling of Complaints Lodged by Foreign-funded Enterprises in Beijing, promulgated by the Beijing Foreign Economic and Trade Commission on 16 March 2001.
32. Maruyama, Warren H. (1999), *US-China IPR Negotiations: Trade, Intellectual Property, and the Rule of Law in a Global Economy* in Mark A. Cohen, A. Elizabeth Bang and Stephanie J. Mitchell (eds., 1999), *Chinese Intellectual Property Law and Practice,* Kluwer Law International, Boston.
33. People's Daily, Internet edition, 2 May 2001.
34. All the figures in this paragraph are from the *China Statistical Yearbook*, 2001.
35. All the figures in this paragraph are from the *China Statistical Yearbook*, 2001.
36. As quoted by Li, Wei (2001), *Corruption during the Economic Transition in China*, Working Paper, University of Virginia, Charlottesville, Virginia.
37. Li, Wei (1999), *Corruption and Resource Allocation under China's Dual-Track System*, Working Paper, Duke University, Durham, North Carolina.
38. Fan, Chengsze Simon and Grossman, Herschel I. (2001), "Incentives and Corruption in Chinese Economic Reform", *Journal of Policy Reform*, Volume 4 No. 3.

ANNEX 2

Abbreviations

ASBE	Accounting Standards for Business Enterprises
BAS	Basic Accounting Standard
CCOIC	China Chamber of International Commerce
CCPIT	China Council for the Promotion of International Trade
CICPA	Chinese Institute of Certified Public Accountants
CIETAC	China International Economic and Trade Arbitration Commission
CMAC	Chinese Maritime Arbitration Commission
CNY	ISO-code for Renminbi (national currency of the People's Republic of China)
CPA	Certified public accountant
CSRC	China Securities Regulatory Commission
DAAA	Division of Administration of Accounting Affairs (of the Ministry of Finance)
FDI	Foreign direct investment
FIE	Foreign-invested enterprise
GATT	General Agreement on Tariffs and Trade
ICSID	International Centre for the Settlement of Investment Disputes
IFAC	International Federation of Accountants
IFCAL	International Federation of Commercial Arbitration Institutions
IPO	Initial public offering
IPR	Intellectual property rights
M&A	Mergers and acquisitions
MOFTEC	Ministry of Foreign Trade and Economic Co-operation
MOFCOM	Ministry of Commerce
NBS	National Bureau of Statistics (formerly translated as State Statistical Bureau, SSB)
NPC	National People's Congress (China's parliament)
PBC	People's Bank of China
SAFE	State Administration of Foreign Exchange

SAIC	State Administration of Industry and Commerce
SDPC	State Development Planning Commission
SDRC	State Development and Reform Commission
SETC	State Economic and Trade Commission
SEZ	Special Economic Zone
SOE	State-owned enterprise
TRIMs	Trade-related investment measures
TRIPs	Trade-related intellectual property rights
USD	ISO-code for US dollars
VAT	Value-added tax
WIPO	World Intellectual Property Organisation
WTO	World Trade Organisation

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Chapter 3

Policies and Incentives for Attracting Foreign Direct Investment*

The present article reproduces a report approved in April 2003 by the OECD Committee on International Investment and Multinational Enterprises (CIME). The article comprises two main sections. The first section "Guiding Principles for Policies toward Attracting Foreign Direct Investment" is a statement endorsed by CIME as part of its consideration of incentive-based policies to attract FDI. The second section "Assessing FDI Incentive Policies: A Checklist" was released by CIME with the intention of providing policy makers with a tool against which to assess the usefulness and relevance of FDI incentive policies.

* The report was based on material assembled by Hans Christiansen, Principal Administrator, Capital Movements, International Investment and Services Division, OECD, reviewed and refined by CIME in the course of 2002 and 2003. The project received financial support from the UK Department for International Development.

Guiding Principles for Policies Toward Attracting Foreign Direct Investment

The present guiding principles originate from the OECD Committee on International Investment and Multinational Enterprise's 2001-2002 review of incentives-based competition for foreign direct investment (FDI).

The aim of policies for attracting FDI must necessarily be to provide investors with an environment in which they can conduct their business profitably and without incurring unnecessary risk. Experience shows that some of the most important factors considered by investors as they decide on investment location are:

- A predictable and non-discriminatory regulatory environment and an absence of undue administrative impediments to business more generally.
- A stable macroeconomic environment, including access to engaging in international trade.
- Sufficient and accessible resources, including the presence of relevant infrastructure and human capital.

The conditions sought by foreign enterprises are largely equivalent to those that constitute a healthy business environment more generally. However, internationally mobile investors may be more rapidly responsive to changes in business conditions. The most effective action by host country authorities to meet investors' expectations is:

- Safeguarding public sector transparency, including an impartial system of courts and law enforcement.
- Ensuring that rules and their implementation rest on the principle of non-discrimination between foreign and domestic enterprises and are in accordance with international law.
- Providing the right of free transfers related to an investment and protecting against arbitrary expropriation.
- Putting in place adequate frameworks for a healthy competitive environment in the domestic business sector.
- Removing obstacles to international trade.
- Redress those aspects of the tax system that constitute barriers to FDI.

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- Ensuring that public spending is adequate and relevant.

The usage of tax incentives, financial subsidies and regulatory exemptions directed at attracting foreign investors is no substitute for pursuing the appropriate general policy measures (and focusing on the broader objective of encouraging investment regardless of source). In some circumstances, incentives may serve either as a supplement to an already attractive enabling environment for investment or as a compensation for proven market imperfections that cannot be otherwise addressed. However, authorities engaging in incentive-based strategies face the important task of assessing these measures' relevance, appropriateness and economic benefits against their budgetary and other costs, including long-term impacts on domestic allocative efficiency.[1] Authorities need also to consider their commitments under international agreements. The relevance and appropriateness of FDI incentive strategies should be examined at regular intervals. Transparency and accountability at all levels of governments greatly increases the success of such evaluations.

Investment incentives have effects beyond the jurisdiction that offers them, which need to be carefully considered. Some forms of competition among states for FDI may lead to sub-optimal results for all states, including waste of economic resources and social costs. OECD members and other countries adhering to the OECD Declaration on International Investment and Multinational Enterprises have undertaken commitments in this respect.[2] Under the instrument on International Investment Incentives and Disincentives, which is an integral part of the Declaration, they:

> "… *recognise the need to strengthen their co-operation in the field of international direct investment*";
>
> "… *recognise the need to give due weight to the interests of adhering governments affected by specific laws, regulations and administrative practices in this field providing official incentives and disincentives to international direct investment*";
>
> "… *endeavour to make such measures as transparent as possible, so that their importance and purpose can be ascertained and that information on them can be readily available*".[3]

Furthermore, in 1984 the OECD Council decided upon "… consultations in the framework of the Committee on International Investment and Multinational Enterprises at the request of a member country which considers that its interests may be adversely affected by the impact on its flow of international direct investment of measures taken by another member country which provide significant official incentives and disincentives to international direct investment… [T]he purpose of the consultations will be to examine the possibility of reducing such effects to a minimum." (International

Investment Incentives and Disincentives, Second Revised Decision of the Council, May 1984.)[4]

Against this background the Committee has agreed on a Checklist for Assessing FDI Incentive Policies. The Checklist serves as a tool to assess the costs and benefits of using incentives to attract FDI; to provide operational criteria for avoiding wasteful effects and to identify the potential pitfalls and risks of excessive reliance on incentive-based strategies. The Committee also believe that careful evaluations of the Checklist and its application to considerations of investment incentives can have a positive effect in minimising potential harmful effects of incentives both for those that employ them and for other governments seeking to attract foreign investment.

OECD members furthermore consider that it is inappropriate to encourage investment by lowering health, safety or environmental standards or relaxing core labour standards. The OECD Guidelines for Multinational Enterprises, which are an integral part of the Declaration, state that enterprises should:

> "… *refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues*."[5]

Notes

1. It is at the same time recognised that doing so can in practice be difficult and it requires resourceful and competent public agencies.
2. OECD members most recently reaffirmed their commitment at the 2000 *Review of the Declaration*.
3. Excerpts from Parts IV.1, IV.2 and IV.3 of the *Declaration on International Investment and Multinational Enterprises*, 27 June 2000.
4. Non-member adherents to the Declaration also adhere to the 1984 Decision.
5. The *OECD Guidelines for Multinational Enterprises*, Chapter II, paragraph 5.

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Assessing FDI Incentive Policies: a Checklist

This article reproduces a document released by the OECD Committee on International Investment and Multinational Enterprises to assist national policy makers in deciding whether to apply FDI incentives. The document proposes a Checklist to assess the costs and benefits of using incentives to attract FDI, to provide operational criteria for avoiding wasteful effects and to warn against the pitfalls and risks of excessive reliance on incentive-based strategies.[1] It draws of a large body of analytical work undertaken by various parts of OECD, an overview of which is provided in Annex I. The Checklist has been developed, and needs to be considered, within the framework of the Committee's statement "Guiding Principles for Policies toward Attracting Foreign Direct Investment".[2]

The Checklist should not be read as an endorsement of the use of FDI incentives. It also represents a partial analysis in the sense that the viewpoint of individual jurisdictions is applied throughout. In other words, the Checklist focuses on such challenges and pitfalls as can be addressed by national or sub-national authorities acting on their own. This means that the important additional issue of competition between jurisdictions is left largely untouched. Whilst incentives competition may in some cases contribute to efficiency in the allocation of FDI, there are important risks that these benefits come at an excessive cost to the international community at large. The Guiding Principles for Policies toward Attracting Foreign Direct Investment acknowledge this risk. A similar position is taken by the social partners of the OECD, including in a recent policy statement by the Business and Industry Advisory Committee to the OECD (BIAC), which among other things opined that states should "… be cautious of fuelling an environment where FDI flows primarily to those countries with the 'deepest pockets'…".[3]

Moreover, the Guiding Principles also note that, even from an individual country viewpoint, incentive policies *per se* are hardly ever an optimal strategy for attracting FDI. A large body of evidence shows that investors are principally motivated by the quality a host country's enabling environment. Hence, policies to enhance macroeconomic stability, transparency, other elements of good governance, openness to trade, infrastructure and the levels of know-how in the domestic economy are all more potent tools for attracting investors. FDI incentives may in many cases at most tip the balance in favour

of one location among a group of economies that are perceived to have broadly equivalent enabling environments.

The organisation of the remainder of the article is as follows. Section I aims to establish a common ground as regards the practices that constitute FDI incentives and the outcomes that could be considered as positive or wasteful. Section II surveys and discusses the FDI incentive strategies and policy tools that are available to authorities. Section III lists some of the challenges and risks facing authorities involved in developing and implementing strategies for offering FDI incentives and synthesises the findings into a Checklist of operational criteria for policy-makers.

1. Incentives, competition and wasteful practices: what does it all mean?

Policy discussions of FDI attraction (and in many cases also the work of academic economists) tend to be fraught with confusion, largely due to an absence of a common language. Conceptually different notions such as strategies for FDI promotion, FDI incentives, policy competition and, even, bidding wars are in practice often used interchangeably. The result has been that crucial distinctions between beneficial and wasteful strategies, deliberate *versus* inadvertent resource reallocation, and legitimate self interest *versus* predatory practices have become blurred. The present introductory section aims to establish a few guiding principles for when to categorise FDI promotion strategies as "incentives", "competition" and, crucially, "wasteful".

1.1. FDI incentives

Policies of attracting internationally mobile investors have sometimes formally motivated targeted efforts at improving host countries' enabling environments. Some countries have, for instance, employed particularly low corporate tax rates to attract foreign corporate presence (and induce domestic enterprises to stay). A range of other strategies has included preferential tariff regimes, the cutting of red tape, stepped-up investment in infrastructure and educational measures. Many of the latter have been targeted toward prioritised economic sectors (*e.g.* the high-tech strategies of South East Asia; the "auto regimes" of Latin America) and regions (not least in connection with "special economic zones", "export processing zones", etc.). Others have had as their purpose a general deepening of the capital stock through outright investment subsidies. Even though many such strategies rely for their success on a degree of foreign participation, they cannot be classified as FDI incentives.

FDI incentives, in the sense that they target or give preferential treatment to *foreign* investors, are by nature discriminatory. The definition of FDI

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incentives proposed by the present document is the following: *Measures designed to influence the size, location or industry of a FDI investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors*.[4] Addressing policies to encourage private investment more generally is not the motivation of the present work.

Two categories of measures meet this definition, namely the so-called *rules-based approaches* that rely on discrimination (according to nationality) of investors to be stipulated by law, and *specific approaches* that tailor incentives to individual foreign investors or investment contexts. The rules-based approaches in many cases represent a relatively straightforward selective application of investment subsidies. Specific approaches, on the other hand, produce a multitude of different incentives, including specially negotiated fiscal derogations, grants and soft loans, free land, job training, employment and infrastructure subsidies, product enhancement, R&D support and *ad hoc* exceptions and derogations from regulations.[5] The dividing line between the two categories is, however, in practice often blurred.

An important caveat relates to the practice of considering FDI incentives in isolation, since the definition of such incentives is necessarily narrow. In practice, authorities often offer incentives that are available to any enterprise not previously located in their host economy. Moreover, specific approaches are sometimes applied to enterprises already located in the host economy to encourage expansion and to discourage them from moving away. While such practices may not necessarily meet the strict definition of FDI incentives their effects are economically equivalent, and the policy challenges to which they give rise are in most cases the same.

1.2. Competition for FDI

It should be noted that the usage of FDI incentives in many cases does not imply competition between jurisdictions. Competition may be defined as situations in which authorities are induced to make available incentives or modify the FDI incentives they offer (*i.e.* by making them more generous) as a result of the incentive strategies pursued elsewhere. There would appear to be two separate, albeit interrelated, classes of competition. *Targeted competition* occurs where authorities attempt to attract individual FDI projects by means of outbidding the incentives of other jurisdictions. In doing so they normally apply specific approaches, although there have also been cases of legislation being adapted as part of a bidding process. *Regime competition* relates to the case where the overall generosity (or design) of a jurisdiction's FDI incentives is chosen in response to the incentives practices in place elsewhere. Importantly, regime competition has implications both for the design of rules-

based FDI approaches and for the amounts jurisdictions allow themselves to spend on pursuing specific approaches.

The application of FDI incentives does in most cases not involve targeted competition. It should, however, be noted that systematic and internationally comparable studies of FDI incentives are virtually non-existent, whereby any assessment must rely on case studies and anecdotal evidence. First, a fairly large share of the direct investment projects involving FDI incentives occur where investors have already formed a firm opinion of their preferred location. The issue of incentives thus mostly boils down to bilateral negotiations between investor and host authorities about how the level of risk and loss making (especially at the early phase of projects) can be diminished and about how to partition the difference between the corporate and social yield of the investment. Second, investors who have short-listed a few potential locations may shop around for the most attractive incentives packages, but the authorities of discarded locations generally do not chase the investment by topping up their incentives packages.

However, there have been cases of sharp targeted competition in recent decades. The incentives for authorities to bid against each other are particularly strong where the size of an individual project is large and where investors are relatively indifferent between alternative locations. Consequently, the bulk of the evidence of incentives competition relates to economies that are located within the same geographic area and have comparable factor endowments. Joint work by the Secretariat and the OECD Development Centre indicates that, while there are some documented cases of less developed countries being affected by direct FDI competition from mature economies, there is little evidence to suggest that this is a problem of more general concern.[6]

In some instances, targeted competition for FDI has risen to the level of veritable bidding wars, where jurisdictions not only compete, but continue raising their bids until the eventual incentives reach levels that would appear unfounded in economics. Studies have concluded that this occurs in industries where the project size is not only large, but where the expected benefits to the host economy are big enough to attract the attention of policy-makers. The benefits may come in a number of different forms, including job creation, future tax revenues and the generation of an improved (in many cases, high-tech) business environment. The bidding for such "trophy projects" appears to have been most intense in sectors such as automobiles, petrochemicals, electronics and information technology.[7]

Regime competition appears to be widespread across countries and jurisdictions. Survey responses and anecdotal evidence largely confirm that many of the jurisdictions that offer FDI incentives would prefer not to do so

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and are concerned about the costs. In the words of one local politician "*you can't say no, but you can't afford to say yes*".[8] In a nutshell, most policy-makers feel that they would be unable to attract certain FDI projects if they did not offer an incentive package broadly as generous as the ones available elsewhere.

1.3. Wasteful strategies

The basic aim of a policy of FDI incentives (or any other strategy for attracting FDI) is to maximise the long-term benefits of foreign corporate presence. In doing so it must ensure that the benefits exceed the costs, and that the costs of achieving given goals are kept to their lowest feasible level.

The economic benefits of attracting FDI are generally twofold. First, countries with domestic savings so low that they are insufficient to finance a strategy of economic expansion (or where weak financial intermediation has a similar effect) may harness FDI as a source of external finance. This is assumed to be particularly relevant in the case of developing and emerging economies. Second, foreign corporate presence is, as demonstrated by an ample body of economic literature, generally associated with positive externalities ("spillovers") toward the host economy.

The channels though which the spillovers operate are at least fivefold. Foreign corporate presence may 1) act as a trigger for transfers of technology and know-how; 2) assist enterprise development and restructuring, not least in connection with privatisation; 3) contribute to fuller international (trade) integration; 4) bolster business sector competition; and 5) support human capital formation in the host country.[9] In the case of OECD countries, the first two channels are generally thought to be the most important ones. Indeed, the formal justification of many FDI incentives ("nurturing corporate clusters", "enhancing business competences", "attracting a pool of skilled labour", etc.) implicitly assume that the technology-transfer channel is vigorous.

The presence (and magnitude) of such spillovers is of crucial importance if FDI incentives are to be economically justified. If spillovers were thought to be negligible, host country authorities would, in the absence of financing constraints, be better advised to pursue generic investment promotion policies.[10] This observation is non-trivial for another reason: since externalities are generally thought to vary between economic sectors, FDI incentive policies will either have to discriminate between sectors as well, or take into account a certain amount of waste.

Based on the above, it appears that the criteria for characterising particular FDI incentives as being "wasteful" from the host country perspective have at least two dimensions. First, individual jurisdictions may pursue practices *vis-à-vis* investors that are inoptimal *per se*, or the

wastefulness may derive from the response to such practices by competing jurisdictions. Second, applying an inter-temporal perspective, a waste may occur up front, or it may derive from the way a given policy action influences the future "rules of the game". The following individual criteria for wastefulness are proposed:

- *Ineffectiveness*. This is the basic case of wastefulness: the usage of FDI incentives fails to produce benefits to the host economy that exceeds the budgetary costs. This situation may arise where authorities apply faulty cost-benefit analysis (or no cost-benefit analysis at all) to their incentive programmes or where promised benefits do not materialise and conditions applied do not prevent reduced or non payment or recovery of incentives paid.
- *Inefficiency*. This is the case where incentives produce benefits that outweigh the costs, but authorities fail to properly maximise the benefits and minimise the costs. In other words, similar results might have been obtained at a lower cost, whereby the difference between the actual and the potential cost must be characterised as a waste.
- *Opportunity costs*. When the resources available to attract FDI are scarce, the issue of alternative usage of funds arises. Incentive schemes that are both effective and efficient may nevertheless be wasteful if the funds that are sunk into financing them could have been used more profitably.
- Deadweight loss. This term refers to the situation when:
    - Authorities find themselves subsidising investment projects that would, with the benefit of hindsight, have taken place in the absence of incentives.
    - Authorities fail to specify adequately the intended recipients and to circumscribe the application to that group only has resulted in spillover to non-target groups.
    - Authorities, in order to maintain a reasonably level playing field in their domestic business sector, feel obliged to match FDI incentives by offsetting subsidies to other enterprises.
    - Authorities, by offering particularly generous FDI incentives to some projects, effectively "raise the bar", creating a reference point that future investors will use to demand a similar degree of generosity.
- *Triggering competition*. Long-term costs of an incentive scheme include the economic burden that arises if other jurisdictions put in place matching measures. This is of particular concern when putting in place new measures or significantly increasing the generosity of the ones already in place. Doing so without properly assessing the likely reactions of other jurisdictions can in many cases amount to a wasteful practice.

2. Choices, tools and pitfalls for policy makers

2.1. The strategies

When assessing the effect and appropriateness of FDI incentives, the position of investors and policy-makers need to be taken into account. As for investors, an array of possible motivations for investing presents the implementing authorities with multiple challenges – and with multiple risks of "getting it wrong". Many of these are dealt with in detail in the later sections. Regarding the position of policy-makers, at least two dimensions should be considered. First, it matters greatly whether incentive schemes are operated by national or sub-national jurisdictions – *e.g.,* as is increasingly the case, by municipal authorities. Second, the purpose or policy goal that is being pursued through the FDI incentives differs greatly among host locations, not least according to their state of economic development, which may have important implications for an assessment of the value of the incentives. A few special cases are proposed below. (Most investment incentives do in actual practice involve an element of mixed strategies including several individual goals.)

- *Broadly-based FDI incentives.* Authorities may develop a simple strategy aimed at employing FDI incentives to raise the attractiveness of their host economy beyond what can be achieved by improving the quality of the enabling environment. Two distinct categories present themselves:
  - Proactive policies aimed at attracting foreign investors in general. Such strategies may aim at topping up or compounding the general advantages of the host economy's enabling environment, for instance by making relocation easier and less costly or by seeking to cover the initial loss-making period of an investment.
  - Defensive strategies with their scope generally limited to matching the generosity of investment incentives on offer elsewhere.
- *Targeted strategies*. Most strategies for attracting FDI by means of incentives are limited in scope, in the sense that they focus on specific aspects of the host economy. The following four types of strategies appear to be commonplace:
  - Regionally oriented strategies aimed at attracting foreign enterprises to economically depressed areas or in response to the closure of another plant. National authorities may devise such strategies, or sub-national authorities may enjoy (or be granted) sufficient freedom to pursue them on their own.
  - Developing prioritised activities. One of the main examples of such strategies is the setting up (and, in the case of FDI incentives,

subsidisation) of export processing zones with the purpose of integrating the host economy close with international trade.

- ❖ Building on particular advantages. The classic example would be the attraction of labour-intensive industries to countries with an abundant workforce. Many countries have also successfully employed FDI for developing particular service activities such as tourism.
- ❖ Nurturing selected sectors. Some countries and regions attempt to use FDI as a tool for implanting whole new sectors where they have no history or of developing "priority industries" in sectors where they were not previously thought to have particular advantages. This strategy has for instance been applied to the high-tech industries and certain high-value segments of the service sectors but also in high added value projects perceived as desirable (*e.g.* machine tool-making, precision engineering).

- *Improvisation*. Not all FDI incentives are granted as part of concrete or targeted programmes. In fact, it has been observed that some of the most strongly publicised examples of FDI incentives relate to cases where – owing largely to the sheer magnitude of the investment projects – there was a high degree of improvisation on the part of the host area authorities.

2.2. The tools

FDI incentives are commonly divided into three categories, namely fiscal, financial, and regulatory incentives, all of which are financed (or, in the case of regulatory incentives, offered) by authorities in the host area.

The so-called ***regulatory FDI incentives*** are policies of attracting foreign-owned enterprises by means of offering them derogations from national or sub-national rules and regulation. While authorities may in principle choose to derogate from any regulatory practice, the onus has in practice been on easing the environmental, social and labour-market related requirements placed on investors. Such incentives are almost exclusively granted in connection with targeted strategies, or they are specially negotiated as part of the "improvised" strategies for luring large individual investment projects. It should, however, be noted that the evidence of such practices is sparse, anecdotal, and largely confined to specific sectors in non-OECD countries.

Policies of offering ***financial FDI incentives*** are often formally motivated by one of three considerations. First, a host area (or a site within the host area) may be perceived as being disadvantaged relative to comparable sites elsewhere, *e.g.* because of the stage of development in that area. In this case authorities often argue in favour of a targeted effort at assisting investors, which is construed as a policy of levelling the playing field. Such so-called "site equalisation outlays" are in many cases largely generic or available to all

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companies that wish to invest in a given area, in which case they can not be considered as FDI incentives. However, the specific investment packages negotiated between authorities and, in particular, large foreign investors have often included elements such as:

- *Infrastructure subsidies.* One of the preferred ways of increasing the attractiveness of a site (or an area more generally) is by providing physical infrastructure (roads, railways, harbours) or communication tailored to meet the needs of the investors.
- *Job training subsidies.* In many cases – and particularly when investment is sought in activities that are new to the host economy – investors are faced with a shortcoming of qualified labour that authorities offer to alleviate through public or publicly-supported education programmes.

Second, authorities often argue that the costs that enterprises incur when relocating, or establishing new subsidiaries at a distance from previous sites, may hold them back from choosing the most suitable locations. According to this reasoning, it is advisable for the would-be host authorities to offer a subsidy toward meeting the relocation costs. This class of financial incentives includes:

- *Relocation and expatriation support.* Authorities may offer grants to help meet enterprises' additional capital spending and concrete relocation costs. In some cases, host country authorities also contribute toward individual members of staff's removal costs, as well as family-related expenses of expatriate members of staff.
- *Administrative assistance.* Authorities may resort to implicit subsidisation, whereby for example investment promotion agencies (IPAs) take upon themselves, as part of their competitive client service approach, to perform a range of tasks that would otherwise have fallen on the investing enterprises. Examples include preferential treatment by regulatory authorities whereby administrative impediments – such as for example the speed of obtaining permissions – are eased.
- *Temporary wage subsidies.* The start-up phase can be further supported through the temporary coverage of part of the new corporate unit's wage bill.

Third, in addition to the above two categories of FDI incentives that are generally justified by the wish to correct market imperfections and overcome transaction costs, authorities may attempt to simply reap the supposed externalities of foreign corporate presence through a policy of targeted incentives. (This applies equally to the fiscal incentives listed below, many of which are quite "blunt" and unsuited to address specific market failure.) However, since political constraints generally compel host authorities not to be perceived as handing out gifts to foreign-owned enterprises, such subsidies

tend to be tied to specific activities by investors that it seems opportune for authorities to encourage. Examples include:

- *Credits to investors*. Authorities may choose to grant soft loans or interest subsidies to foreign enterprises for the specific purpose of an investment project. Alternatively, they may ease investors financing costs by issuing loan guarantees.
- *Real estate*. There are many cases of national or local authorities selling land or buildings to foreign investors at below market values. Insofar as the real estate was not previously used, such practices are being seen by many as a virtually cost-free way of promoting investment (whereby the opportunity costs are being ignored).
- *Cost participation*. In addition to helping investors cover their start-up costs, authorities sometimes go in for the "longer haul". In return for an opportunity to affect investors' business dispositions, they may contribute toward marketing and developing costs and even, in some cases, ordinary operating costs. Cost participation may be direct, or it may be given indirectly via the suppliers of goods and services to the investor.

Various studies have concluded that the most commonly used inducements are ***fiscal FDI incentives***. This particularly applies to non-OECD member countries, which have limited funds available for financial incentives.[11] Where fiscal measures are used to attract FDI into OECD countries they usually take the form of rules-based approaches, since changes in taxation in most cases require legislative action.[12] More specifically, and recalling that incentives are often offered jointly as a complex "package", a representative list of individual fiscal incentives that are currently being offered by some jurisdictions includes:

- *Reduced direct corporate taxation*. General measures aimed at easing the corporate tax burden are used to attract foreign direct investors. These include:
  - Reduced rates of corporate income tax. Whereas a general lowering of corporate tax rates relates to the enabling environment for investment, some jurisdictions have targeted such measures at incomes from specific sources, or at income earned by non-resident investors alone.
  - Tax holidays. Under a tax holiday, qualifying "newly-established firms" are not required to pay corporate income tax for a specified time period. A variant is to provide that a firm does not pay tax until it has recovered its up-front capital costs.
  - Special tax-privileged zones. The creation of "ring-fenced" areas with low rates of corporate taxation amount to fiscal FDI incentives in the cases

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where foreign-owned enterprises enjoy privileged access to operate in such zones.

- *Incentives for capital formation*. Policies of tying lower taxation to corporate investment are used by many jurisdictions as a way of conjointly attracting foreign enterprises and providing them with incentives to invest. The examples include:
  - Special investment allowances. Under such allowances, firms are provided with faster or more generous write-offs for qualifying capital costs. They may take the form of accelerated depreciation or enhanced deductions.
  - Investment tax credits. Such tax credits are earned as a percentage of qualifying expenditures and offset against taxes otherwise payable.
  - Reinvested profits. Some jurisdictions offer deductions or tax credits against profits that are reinvested in the host economy.
- *Reduced impediments to cross-border operation*. Companies are attracted to locations where the fiscal system imposes minimal costs on the cross-border transfer of funds, goods and services and manpower. Some of the incentives on offer are:
  - Withholding tax. Some countries offer foreign-owned enterprises reduced rates of withholding tax on remittances to their home countries.
  - Taxation of foreign trade. Reduced import taxes and customs duties (and in some cases export taxes) are sometimes used as FDI incentives – for instance where export processing zones are not accessible to domestic enterprises.
  - Taxation of employees. Lower personal income tax or social security reductions for expatriate executives and employees are used to make locations more attractive to foreigners.
- Other tax reductions. The selective lowering of any tax rate affecting the enterprise sector may be used to attract foreign enterprises. Currently, some jurisdictions use lower sales taxes and VAT reductions as an incentive; others offer foreign-owned enterprises property tax reductions. An interesting special case relates to a practice in some non-OECD countries of offering foreign-owned enterprises the option of choosing a lump sum payment in lieu of taxes, with the purpose of providing them with incentives to boost their economic activity in the host economy.[13]

3. Challenges for policy makers: a checklist

The previous sections have drawn up a quite complex matrix of potential benefits, but in particular also costs and pitfalls that policy makers embarking on an FDI incentive strategy need to take into account. Precisely because of the

complexity of the issues and the trade-offs between competing objectives, great caution is called for when, or if, FDI incentives are put in place. At a minimum it would appear recommendable that one coherent and encompassing policy should be developed in each jurisdiction. The authorities drawing up such a policy need to be well placed to take into account not just the process of attracting foreign investment, but also the overall budgetary and regulatory implications and the role of foreign direct investment in business sector development more generally.

Once policy-makers have agreed on their preferred strategies for FDI attraction, the design of the appropriate policies presents them with a further array of complex choices. Hence, to avoid negative outcomes policies guiding FDI incentives should be anchored in a strategy spelling out the measurable objectives to be pursued. (This is important not just for the sake of policy coherence, but also because the economic benefits of FDI tend to occur gradually and can be hard to verify.) By tying the incentive policies to a set of verifiable objectives, their efficiency – or wastefulness – becomes easier to evaluate. Furthermore, strategies would need to be developed with due regard to the funds available for their implementation, whereby their formulation is intrinsically linked with the budgeting process of the implementing jurisdiction.

The following subsections list some of the most crucial policy choices that need to be made and proposes operational criteria against which the relevance, quality and coherence of a policy framework can be assessed. Again, the purpose of the listing is not to recommend or prescribe courses of action. Rather, the intention is to alert policy-makers to some of the questions that present themselves when a jurisdiction embarks on a policy of offering FDI incentives. The criteria fall into six broad categories, namely *a)* the desirability and appropriateness of offering FDI incentives, *b)* frameworks for policy design and implementation; *c)* the appropriateness of the choice of strategies and policy tools; *d)* the design and management of individual programmes; *e)* transparency of procedures (*i.e.* evaluation, monitoring and follow-up); and *f)* assessing the extra-jurisdictional consequences of FDI incentive strategies.

3.1. The desirability and appropriateness of offering FDI incentives

Question 1: Are FDI incentives an appropriate tool in the situation under consideration?

Incentives are hardly ever a first-best option. Significant improvements of the enabling environment for investment (*e.g.* the removal of undue impediments and improvement of regulatory frameworks) can often be achieved at a low budgetary cost and should be considered.

Question 2: Are the linkages between enabling environment and incentives sufficiently well understood?

Where shortcomings in the enabling environment cannot be addressed in the near term authorities may perceive a need to rely on incentives. However, unless the incentives go some way toward correcting the concrete shortcomings, their impact on investors is uncertain.

In formulating an FDI attraction policy, authorities should start by developing a realistic view of what can, and can not, be achieved. As mentioned earlier, FDI incentives are no substitute for an attractive enabling environment for foreign direct investment. Where, as is usually the case, investors are attracted by risk-adjusted expected returns, any effort at improving the business climate or reducing risk may potentially have a similar, or larger, impact on investment than incentives. There is a danger that the practice of offering FDI incentive policies may even distract policy makers' attention from more relevant policies toward improving the business climate.

Furthermore, if a need to top up the enabling environment is perceived, it is often better met through general investment promotion strategies than FDI incentives. A policy of offering incentives selectively to foreign enterprises carries considerable risk of hurting rather than improving the domestic business environment.[14]

3.2. Frameworks for policy design and implementation

Question 3: What are the clear objectives and criteria for offering FDI incentives?

The relevant authorities need to establish what FDI incentives are meant to achieve, and how. In the absence of sufficient clarity about this, evaluation of the appropriateness and effectiveness of policies is impossible.

Question 4: At what level of government are these objectives and criteria established, and who is responsible for their implementation?

It should be made clear within each jurisdiction who is ultimately responsible for the formulation of policies. Other public bodies involved in the design and implementation of FDI incentives should then be accountable to this authority.

Question 5: In countries with multiple jurisdictions, how does one prevent local incentives from cancelling each other out?

Competition between jurisdictions may lead to efficiency gains when founded in genuine efforts to improve the business climate. However, a purely competitive subsidisation of enterprises often has the opposite effect. In the latter case, central authorities may have the option of encouraging co-operative arrangements between jurisdictions.

National authorities (or the lowest levels of government that have legal jurisdiction, in the case of a federal system) need to decide how much power of decision to devolve to lower levels of government. This choice is influenced by the nature of FDI incentive strategies that are pursued. Those jurisdictions that choose general strategies, or sectoral strategies that are tied closely to general industrial policy, have less incentive to devolution than those who focus on the regional aspect of FDI attraction (or, of course, those who are bent on "chasing anything that moves"). The main advantage of giving the local level a freer hand lies in the more intimate knowledge of industries and individual investment projects that is available locally, but this comes at a risk of triggering competitive bidding and other wasteful practices within the jurisdiction.

The actual implementation of FDI promotion activities is in most cases left to specialised IPAs, which often enjoy a high degree of autonomy and are supervised directly by domestic policy makers.[15] However, given the diversity of incentive measures and the different levels of government involved, the main responsibility for implementing FDI incentive policies in several countries rests outside these specialised agencies, which in those cases limit themselves to an advisory and intermediary role. Regardless of the placement

of the administrative and political responsibilities, it is commonly agreed that the implementation of FDI incentives should be guided by a set of clear predetermined policies communicated to the competent authorities by policy makers. High standards of accountability and disclosure *vis-à-vis* the general public are also helpful creating clarity and building support for the government's strategies.

It may, however, be difficult in practice to hold policy implementation to such high standards. In some cases, the management of incentive programs is, for instance, made more difficult by political pressures and media speculation. It is notoriously difficult for public sector managers to negotiate with a potential investor when the contents of negotiations are at the same time being debated in the legislature or media. Also, regional or sector-specific programmes are reportedly prone to become subject to political pressures aimed at having their resources applied beyond original mandates. The result can be both ineffective incentives and the breakdown of policy-coherence in the application of FDI incentive strategies.

3.3. The appropriateness of strategies and tools

Question 6: Are the linkages between FDI attraction and other policy objectives sufficiently clear?

A host of policies bear on regional and sectoral developments. It is important to ensure that FDI incentives are not granted in a way that conflicts with other objectives.

Question 7: Are effects on local business of offering preferential treatment to foreign-owned enterprises sufficiently well understood?

Policy-makers' choice will be guided by a joint assessment of the relative benefits of FDI over other sources of investment, the efficiency losses from discrimination and the budgetary costs of non-discrimination.

Question 8: Are FDI incentives offered that do not reflect the degree of selectiveness of the policy goals they are intended to support?

For instance, a jurisdiction with limited resources may be tempted to attract investment by means of fiscal concessions. It would need to consider the fact that such incentives are not particularly well suited to the pursuit of specific economic or regional strategies.

Question 9: Is sufficient attention given to maximising effectiveness and minimising overall long-term costs?

There is a risk of relying excessively on incentives that have little budgetary impact in the near term, while neglecting their longer-term effects. Also, the non-economic costs of most regulatory incentives need to be given proper consideration.

One of the most fundamental strategic choices facing policy makers offering FDI incentives does, as also mentioned in section a, relate to the economic costs of maintaining an non-level playing field. In offering incentives specifically at foreign investors, authorities depart from the principle of non-discrimination. In practice, graduated approaches range from measures that mildly favour FDI to schemes that are exclusively available to foreign entrants. In positioning themselves between the two extremes, authorities need to carefully assess the value of a maintaining a level playing field against the increased costs of making measures generally available. The costs include a direct budgetary effect and an knock-on effect via the health of the domestic business sector:

- The authorities' choice would have to depend on a quantitative assessment of the relative merits of foreign *versus* domestic investment. Also, authorities pursuing comparatively general strategies would normally be

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more concerned than others about the budgetary cost of making investment incentive schemes generally available.

- Once it is known that incentives have been provided to foreign-owned enterprises, or that discretionary incentives might be available, other investors may threaten to move away (or hold back on investment as a negotiating ploy). The likely winners are the more mobile businesses that are able to gain incentives in response to such threats. The losers are businesses unable or unwilling to threaten mobility. Smaller firms, in particular, may be disadvantaged by their lack of capacity to negotiate an incentive agreement.

Not all types of FDI incentives are equally suited to the pursuit of different categories of FDI attraction strategies, but the relative merits of each type have to be weighed against its budgetary implications. Generally, financial incentives leave authorities with more leverage over the actions of the recipients and are therefore more suited to targeted FDI strategies. Similarly, they are easier to use in policies of compensation investors for structural disadvantages. However, national FDI incentive policies in many countries appear to rely excessively on fiscal incentives. The reason for this is that the up-front budgetary impact of deferred or foregone tax revenues is much smaller than the direct outlays needed for financial incentives. Authorities should heed the risk of being too sanguine about the cost of fiscal incentives. Their actions need to be guided by careful assessments of the present value of future foregone revenues.

3.4. The design and management of programmes

Question 10: Are programmes being put in place in the absence of a realistic assessment of the resources needed to manage and monitor them?

Even well-designed programmes may falter if adequate administrative resources are not available. FDI incentive strategies are unlikely to succeed unless the implementing authorities acquire top-level business expertise and develop sufficient capability to make quick decisions without compromising their analysis.

Question 11: Is the time profile of incentives right? Is it suited to the investment in question, but not open to abuse?

Investors' preference for front-loaded schemes has to be assessed against background of the nature and likely duration of their involvement in the local economy. While authorities will want to signal their long-term commitment, they need to guard themselves against predatory practices.

Question 12: Does the imposition of spending limits on the implementing bodies provide adequate safeguards against wastefulness?

Spending limits may include effectiveness targets (*e.g.* maximum spending per dollar of investment or per expected new job), a ceiling per project and a total annual budget. However, it is not always clear how effective such spending limits are in curbing waste due to inefficiencies and opportunity costs. They have to be supplemented by evaluation tools (including cost-benefit analysis).

Question 13: What procedures are in place to deal with large projects that exceed the normal competences of the implementing bodies?

Standard procedures may have to be drawn up, including a prior agreement on what branches of the executive should be involved, and what minimum level of analysis they should be expected to perform. Also, it should be decided at what point and to what degree that elected officials are to be involved in the process.

Question 14: What should be the maximum duration of an incentive programme?

Fixed duration allows for a regular evaluation of programmes assessing their continued relevance, thereby reducing a risk that FDI incentive programmes are kept alive due to administrative or political inertia. Factors such as the political cycle, the sectoral specifics of investors and the time horizon for the development of a given locality may have to be taken into account.

Minimising the deadweight loss (as indicated above this denotes the risk of paying subsidies toward investment projects that would have taken place anyway) is one of the most important challenges for policy makers. This too involves a trade-off between discrimination and budgetary costs, for general FDI incentives necessarily involve a greater risk of deadweight losses than measures that can be applied subject to discretion. However, risk of the latter contributing to deadweight losses as well may increase over time. A jurisdiction that has a history of offering generous FDI incentives finds it difficult to deny new foreign investors a similar degree of generosity.

The time profile of incentives is also important. It has often been argued that FDI incentives should not be too front-loaded. The risk is that "rent seeking" or "footloose" investors will stay only until the incentives ends (or until they are offered more by a competing jurisdiction). This is particularly the case where FDI incentives are general and transferable, such as cash payments and up-front tax breaks. On the other hand, a political willingness to commit FDI incentives up-front is often seen by investors as essential to offset the loss-making early period or as an important signalling device through which authorities make it clear that they bet on a long-term relationship.

Authorities may also choose to couple the offering of front-loaded incentives with demanding that investors undertake certain contractual obligations (*e.g.* undertake subsequent investments). However, a fine balance would need to be struck. In particular, contractual obligations should generally not rise to the level of actual performance requirements, which numerous studies have concluded are counter-productive from the viewpoint of attracting and benefiting from FDI. Performance requirements as such are limited or proscribed by many international investment agreements.

To discourage investors from opting out, many incentive agreements contain "claw-back" provisions in the event investors fail to meet their obligations, including formal recovery and payback procedures. Tied to this is the existence of parent company guarantees and similar contractual arrangements that give strong assurance of limits on incentives expended. However, such contractual undertakings can be difficult to monitor unless carefully constructed, and investors may in most cases cite "market conditions" and scale down or leave before meeting their obligations under any incentive agreement.

At the more practical level, a number of jurisdictions appear to have a tendency to underestimate the resources needed for an efficient implementation. Many implementing authorities lack the data, the expertise,

the special skills, and the senior management time required by incentive programs. In particular:

- Incentive programs are resource intensive to finance and to manage, and, in particular, most incentives are administratively burdensome. Administrative requirements and capacities need to be taken into account when any programme or piece of legislation is being considered.
- Negotiation of incentives requires special negotiating skills and expertise in the application of particular instruments. The investor will be well supported in that regard. Moreover, investors have – and expect from the competent authorities – a speed of decision-making that exceeds normal bureaucratic standards.

Finally, a caveat relates to the actual value of incentives to investors. First and foremost, it is one thing for governments to share the risk of an initial investment in a new location, but the investment has to make business sense without the support of public funds. The design of FDI incentives needs to be carefully considered, not only in terms of creating macroeconomic or sectoral subsidies, but with an eye to the concrete benefits to individual investors.

The value and costs of fiscal incentives can vary considerably depending on the investor's circumstances and the nature of its presence in the host country (*e.g.* through a subsidiary or a branch). Other important factors include the tax laws of the home country, as well as agreements – or the absence of agreements – governing taxation between the home and host countries. In fact, it has been asserted that many incentives on offer are of little relevance or interest to the investors that are being targeted. Unless an incentive package represents a meaningful cost reduction and goes directly to the firm's bottom line, its value could be discounted despite the possible costs to the implementing authority.

3.5. Transparency and evaluation

Question 15: Have sound and comprehensive principles for cost-benefit analysis been established?

Cost-benefit analysis should be applied not only to individual projects, but also taking into account the overall FDI policy context. A commonly accepted methodology for cost-benefit analysis could be established and applied throughout, or alternative methods be used depending on regional and sectoral specifics. Common standards would probably have to be applied to the valuation of non-budgetary costs and benefits.

Question 16: Is cost-benefit analysis performed with sufficient regularity?

Cost-benefit analysis should preferably be performed both prior to investment projects and after a period of time. In order to ensure compliance, formal reporting requirements may have to be imposed.

Question 17: Is additional analysis undertaken to demonstrate the non-quantifiable benefits from investment projects?

A host of national strategies for attracting FDI are formally justified by the presence of non-quantifiable benefits (*e.g.* spillovers). If strategies are to be maintained over time, authorities should therefore be expected to provide *ex post* evidence of such benefits. The analysis could include a whole range of indicators, such as the likelihood of linkages with local business, the impact on value chains and the "quality" of employment.

Question 18: Is the process of offering FDI incentives open to scrutiny by policy-makers, appropriate parliamentary bodies and civil society?

Implementing authorities have incentives to sub-optimising – for instance by measuring success by the number of investment projects they attract. – so a sufficient degree of transparency around their activities must be safeguarded. Agents such as national audit courts, academics and industry itself could be involved in order to raise public and political awareness.

The FDI attraction strategies should be communicated to the enterprise sector (and civil society) in a timely and transparent manner. While the implementation of strategies at the individual company level may, depending on the circumstances, necessitate an element of discretion and confidentiality, authorities have strong incentives to make their general thrust clear to investors. First, this has an important signalling effect *vis-à-vis* these enterprises that are relevant to strategies pursued. Second, it gives the enterprises sector at large an opportunity to inform themselves and

communicate any misgivings to the relevant authorities, which need to take such information into account in the design and evaluation of their strategies.

The relevant authorities need to review the relevance and appropriateness of their FDI incentive strategies at regular intervals and make the results public through annual reports or other communications with the public. In addition, elected officials, for instance through parliamentary bodies, and national audit courts may choose to perform evaluations of their own. In doing so they may not wish to rely solely on the assessments of the implementing agencies. For example, they have the option of involving business sector representatives, national audit courts, the academic community and international organisations in discussions about the role of FDI incentives.

Conversely, if proactive communication strategies are considered as being too resource intensive for some authorities, a policy of disclosing a "sufficient" amount of information to the general public should be pursued. This would allow any interested party outside the government to analyse the costs and benefits of incentive programmes, *ex post* if not *ex ante*.

It follows from several of the points already made that a crucial prerequisite for avoiding wasteful FDI incentives is the implementation of sound and comprehensive practices for cost-benefit analysis. The analysis does, at a minimum, need to develop an assessment of the total benefits derived from foreign direct investment projects, and of the total costs not only to the public purse but to the host economy as a whole. Doing so in practice involves numerous challenges, some of which are:

- Good, professional cost-benefit analyses and programme evaluations cost money. The latter may also require legislative authority.
- It is not always clear at what point in time cost-benefit analysis should be applied. It may for instance be done before a specific incentive "deal" is reached or after the deal has been in operation for some time. Also, the entire policy or strategy may be made subject to cost-benefit analysis. Ideally, all three categories of analysis should be undertaken, but resource limitations may in practice preclude this.
- There is no common agreement about what exactly to include in cost-benefits analysis. A number of cost benefit models (and programme evaluation models) exist, but all of them have recognised limitations. Moreover, important provisos relate to the quality of data available and to the implementing authorities' possible incentives to over-report the success of their activities. More specifically, this raises some additional challenges:
  - Typical quantitative methods require reliable, current data (and data collection capacity), as well as persons with the technical expertise to

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carry out the analysis, and to benchmark results against other jurisdictions or programs.

- Those offering incentives should not be excessively dependent on investors for critical information affecting possible analysis or commitments, a determination of opportunity costs, or the monitoring and evaluation of incentive programs.
- Specific problems may arise when assessing the cost of fiscal incentives. For example, the subsidies involved in the granting of investment tax credits can be so deep that corporations cannot use all their credits and are owed additional revenue back from the fiscal authorities almost indefinitely, thereby creating a very long-term and somewhat unpredictable fiscal liability.

Some more practical problems with monitoring programmes and investors may also present themselves. An important challenge for authorities is the complexity of the relationship between investors and authorities, which may dent their analysis and make them rely on hearsay. Agreements that make no provision for subsequent or periodic monitoring and evaluation, and the publishing of the results, can lead to a failure to perform, to a lack of accountability, and to a loss of mutual trust.

Unclear agreements between investors and authorities – several different authorities, in some cases – are sometimes drawn up, which are difficult to manage, monitor and enforce. In more extreme cases a general lack of clarity may expose authorities to opaque or dishonest practices by investors. For instance, incentives may invite abuses, such as aggressive tax planning techniques, transfer pricing, “round tripping”, “new firms for old” or the sale of duty-free imports. Grants or other discretionary incentives can even give rise to corruption or bribery.

3.6. Extra-jurisdictional consequences

Question 19: Have authorities ensured that their incentive measures are consistent with international commitments that their country may have undertaken?

Certain types of incentives (notably regulatory ones) may be limited by international agreements. International commitments not directly linked with investment may nevertheless have repercussions for FDI incentives.

Question 20: Have authorities sufficiently assessed the responses that their incentive policies are likely to trigger in other jurisdictions?

There is a risk that pro-active steps toward subsidising FDI will lead to bidding wars with other jurisdictions. This risk could be particularly large where large individual projects and the ad-hoc pursuit of specific FDI approaches are involved.

The risk of triggering retaliation needs to be carefully assessed. Individual authorities are unable to take action by themselves to avoid potentially wasteful bidding wars. However, they need to take into account the responses their planned policy action is likely to trigger elsewhere. If, for instance, the predictable outcome of raising the generosity of a given FDI incentive scheme is a bout of offsetting increases in other jurisdictions then the rise will almost certainly have to be considered as wasteful. This consideration applies to all kinds of FDI incentives, but with regime competition apparently pervasive and of long duration, authorities main point for caution should arguably be the ad-hoc application of specific approaches. Some federal states have taken steps to limit the risk of such outcomes within their domestic economy. One example is Canada, the experiences of which are summarised in the text box.

Policy-makers have sometimes found that the offering of incentives invites legal challenges because the policies may be considered to be contrary to either national law or international obligations such as the WTO agreement.[16] In addition, the discriminatory nature of FDI incentives implies that they may effectively distort competition, which may bring them in conflict with competition legislation and, hence, bring them under the scrutiny of national or super-national competition agencies. The most widely quoted example of disciplining investment incentives as an aspect of competition policy is the EU's rules on state aids. Articles 87, 88 and 89 of the Treaty of the European Community prohibit or limit financial or fiscal support by a government to a firm, industry or region, and in so doing limit the measures that states may use to encourage inward investment.

A special case relates to regulatory incentives. The consensus view is developing that such incentives should not be used for targeted FDI attraction, for the risk of contributing to what has been phrased "race to the bottom" and "regulatory freeze" scenarios. Such practices are discouraged by international investment policy instruments, including the OECD Declaration on International Investment and Multinational Enterprises. NAFTA's Article 1114, for instance, includes language effectively proscribing many kinds of regulatory incentives.[17]

Box 1. **The Canadian experience with curbing incentives competition**

Canadian policy regarding the offering of incentives to lure business investments in competition with other jurisdictions within Canada consists of two elements. The first element is the Agreement on Internal Trade (AIT) that was signed by the federal and provincial governments in 1994. Secondly, legislation in most provinces prohibits Canadian municipal governments from offering "bonuses" or firm-specific incentives to lure businesses to their jurisdiction from elsewhere in Canada. The latter element of Canadian policy may arguably have had the greater impact.

Article 607 of the AIT provides that "parties to the agreement may not discriminate against an enterprise on the basis of ownership, control or location of an enterprise within Canada. Annex 607.3 establishes a "code of conduct" on incentives which requires parties to the AIT not to offer "poaching incentives" and to make "best efforts" to avoid incentives that distort economic activity.

Canada's AIT is not principally a tool for central influence over sub-national levels of government. Rather, the primary reason for the prohibition of sub-national incentives is a consensus amongst municipal leaders that they do not wish to compete with each other by offering investment shifting incentives, for fears of getting caught up in situations such as the "prisoner's dilemma". It was in response to requests from municipal leaders that provincial governments moved to outlaw "bonusing" by municipal governments. While the original intent may have been limited to not luring existing businesses from one Canadian jurisdiction to another, the practice, if not the laws, has prevented municipalities from offering incentives to attract greenfield investments from outside the country.

However, while the original consensus amongst municipal governments appears to be holding, provincial governments themselves have appeared less stringent in applying the principle. Canadian policy is therefore very much a "bottom-up" one. More recent efforts by the federal government, to strengthen the rather "soft" provisions against incentives in the AIT, have seemingly enjoyed less priority amongst provincial Ministers.

Notes

1. FDI incentives include tax and other fiscal inducements, financial subsidies and derogations from regulation offered to foreign-owned enterprises with the purpose of making them invest.
2. An overview of other work prepared for the Committee in relation to FDI incentive policies is provided in the last section of this document.
3. "Investment: BIAC Position on Incentives", Statement by BIAC, 5 November, 2002.
4. This draws on a generic definition of investment incentives proposed by UNCTAD (1994), World Investment Report.
5. For an overview of the anecdotal evidence, see C. Oman (2000), *Policy Competition for Foreign Direct Investment*, OECD Development Centre.
6. The few cases that were documented related to countries with a relatively similar factor endowment to the mature economies, which are situated in geographic proximity to the countries with which they have found themselves in competition.
7. Examples are provided by T.H. Moran (1998), *Foreign Direct Investment and Development: The New Policy Agenda for Developing Countries and Economies in Transition*, Institute for International Economics, Washington DC. A recent further illustration is the investment car manufacturers in Central Europe, which have reportedly in some cases involved FDI incentives exceeding USD 200 000 per job created.
8. Stephen Goldsmith, Mayor of Indianapolis as quoted in J. Schwartz and T. Barret, with F. Washington, B. Fisher, and L. Rodado (2001), *Can You Top This?*
9. For a discussion, see OECD (2002*), Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*.
10. This observation is developed by M. Blomström, "The Economics of FDI Incentives" in OECD (2002), *International Investment Perspectives*, Vol. 1.
11. Other cases relate to countries in which authorities have a comparatively high degree of discretion in their application of corporate tax rules.
12. For a thorough discussion of fiscal incentives, see OECD (2001), *Corporate Tax Incentives for Foreign Direct Investment,* OECD Tax Policy Studies, No. 4.
13. A more limited scheme that may be characterised mainly as a transparency-building measure is Chile's practice of offering foreign-owned enterprises a pre-announced corporate tax rate to be held constant over the medium term.
14. This is especially a problem where there are plenty of potential investors in the domestic economy. Conversely, where domestic investors are scarce investment incentives can be made generally available at little or no additional budgetary cost.
15. This is, for example, discussed in more detail in OECD (2002), *Best Practice Investment Promotion Strategies*, South East Europe Compact for Reform, Investment Integrity and Growth.
16. No part of the WTO agreement bears directly on investment subsidies. However, the Agreement on Subsidies and Countervailing Measures prohibits subsidies contingent upon export performance and subsidies contingent upon the use of domestic over imported goods, which has in some cases curtailed investment incentives. Moreover, the WTO Agreement on Trade-Related Investment Measures

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disciplines the performance requirements that are sometimes imposed in tandem with the offering of investment incentives.

17. The Article stipulates that "… it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor."

ANNEX 1

Recent OECD Work in the Area of FDI Incentives: an Overview

This Annex summarises the main distinctive findings of papers discussed at the Committee's "stocktaking exercise" in September 2001 and subsequent pieces of analytic work that have addressed the issue of FDI incentives. The following subsections are organised according to the chronology of the contributions. The overview of the findings is indicative rather than exhaustive of the large body of work undertaken by several OECD bodies in the area of investment incentives. The mentioning of work that has been reviewed and derestricted by the Committee commences by the word CIME in square brackets.

1. The CIME stocktaking exercise

1.1. General studies

[CIME] A consultant paper prepared by ***Professor Magnus Blomström*** discusses the overall pros and cons of offering FDI incentives.[1] It argues that the use of investment incentives focusing on foreign firms is not a recommendable strategy. The main argument in support of this is that the strongest theoretical motive for financial subsidies to inward FDI tends to be external effects such as spillovers of technology and human capital, which do not follow automatically from foreign direct investment. In other words, it is not clear that FDI has an advantage over other kinds of investment. Also, the quality of the enabling environment for investment – which affects a country's ability to attract FDI, and to benefit from it – is equally important to domestic investors. Hence, rather than proposing narrowly defined FDI policies, attractive terms to investors should be seen as part of a country's overall industrial policy and be available on equal terms to all investors, foreign as well as domestic. Incentives should, following the same logic, focus on those

activities that create the strongest potential for spillovers, including linkages between foreign-owned and domestic firms, education, training and R&D.

A report by Charles Oman of the ***OECD Development Centre*** emphasised the developmental impacts of FDI incentive policies.[2] It observes that, while there has been a global increase in FDI incentives as barriers to investment have fallen, most incentives-based competition remains intra-regional. The report draws the policy conclusion that it can be counterproductive and very costly for a government to offer investment incentives if the "fundamentals" of the potential investment sites fail to meet serious investors' basic requirements. In fact, many of the government that have been successful in attracting FDI are also among those that best meet the requirements for good governance. Moreover, while governments often formally justify FDI incentives with a need to steer corporate investment to poorer areas within the host economy, it appears that in practice incentives are of limited effectiveness in this regard. The report recommends a broad reform of policy-making including regulatory reform, privatisation and liberalisation of trade policies (external as well as internal) as a key element in a developing country strategy to attract FDI. It further highlights the need to raise levels of accountability and transparency to limit the risk of illicit practices developing in connection with investor attraction strategies.

1.2. Fiscal incentives

A report by the ***OECD Centre for Tax Policy and Administration*** reviews various types of corporate tax incentives for FDI and debated some of the arguments that are often advanced for their use.[3] The report considers the role of corporate taxation in a country's tax mix, reviews the likely channels of influence of main tax incentive types and surveys empirical evidence of the sensitivity of investment to host country tax burdens. While the report stops short of policy recommendations, it nevertheless applies a cautionary view on incentives. First, it is far from clear that "general" incentives like corporate tax concessions can be used to address specific market imperfections. Second, it notes that a paucity of information in general – and not least as regards the incremental impact of tax incentives on investment decisions – makes authorities decide about tax strategies amid great uncertainty. Third, the choice of alternative tax incentives is found to be strongly dependent on specific country circumstances. For example, the findings in the report call for caution in the use of up-front tax incentives, particularly if the basic statutory corporate income tax rates in the host economy are relatively high, and if refund provisions are offered.

1.3. Regulatory incentives

[CIME] A paper provided by ***Dr. Valpy Fitzgerald*** reviews recent evidence relating to FDI incentives in the regulatory domain.[4] The key issue addressed in this paper is whether competition between host countries on the basis of their regulatory regimes has any effect on the level and "quality" of inward FDI and whether such competition leads to a welfare loss to that country or internationally. The paper finds ambiguous evidence regarding the existence, effect and consequences of regulatory competition for FDI. Importantly, there is little systematic evidence in literature of a "regulatory race to the bottom" and, more generally, there appears to be no robust indication that environmental or labour standards are negatively associated with investment inflows. Conversely, while anecdotal evidence indicates that investors may be increasingly attracted to host countries with high social and environmental standards (*i.e.* a potential "race to the top" scenario), there is little solid research to substantiate this either.

A report published by the ***OECD Directorate for Education, Employment, Labour and Social Affairs*** focusing on international trade and core labour standards includes sections about the impact of FDI.[5] The report concludes that there is no robust evidence that countries with low labour market standards provide a haven for foreign-owned firms. This finding is further supported by the fact that a sharply increasing share of FDI flows to the service sectors and affects employees with better-than-average work conditions. On the specific issue of export processing zones the report notes that national labour and industrial relation legislation is applicable to companies on the zones. However, there are some examples to the contrary, such as zones where collective bargaining and industrial action are proscribed. These zones appear to be mainly attracting investors who depend on cheap labour and move very easily to new locations. Hence, the selective lowering of labour market standards would not appear to be a sound strategy toward FDI-backed longer-term economic development.

A paper prepared for the Environmental Policy Committee's ***Working Party on Global and Structural Policies*** provides a comprehensive literature review of the environmental implications of competition for investment.[6] The paper takes stock of some existing evidence that a "race to the bottom", "pollution havens" and "regulatory freeze" may be possible, particularly in certain resource intensive sectors, but concludes that systematic empirical evidence is still lacking. Some evidence is actually to the contrary. The private sector has in many cases showed an unwillingness to invest in countries with particularly lax environmental laws and standards, because the cost of environmental compliance is limited whereas the reputational cost of benefiting from low standards abroad can be considerable. Designated areas

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for FDI such as export processing zones do, according to the paper, rarely offer lower environmental standards than elsewhere in the host economy. In some cases they even strive toward higher standards as a way of attracting highly skilled staff.

1.4. Disciplining FDI incentives

A paper prepared for the ***Working Party of the Trade Committee*** examines the degree to which multilateral and regional trade agreements may act to prohibit, limit or moderate the use of incentives to attract FDI.[7] The paper surveys the following agreements: 1) the WTO Agreement on Subsidies and Countervailing Measures, which prohibits those specific subsidies that distort trade; 2) the State Aid provisions of the EU, which ban forms of governmental support that may be argued to distort competition; 3) the North American Free Trade Agreement, which restricts the use of regulatory incentives and limits the ability of governments to impose performance requirements; and 4) the APEC Non-Binding Investment Principles, where members have agreed not to reduce regulatory standards on health, safety, or environment as a means of attracting investment. However, the paper concludes that with the exception of the EU regime on state aids, no agreement imposes direct disciplines on the granting of investment incentives. Moreover, few international disputes have to date challenged an FDI incentive programme, which may be taken to indicate that the present rules are not particularly wide-ranging (or that it is difficult to successfully state a claim under them).

A paper prepared for the Committee on Competition Law and Policy's ***Working Party No. 2 on Competition and Regulation*** included sections dealing with "subsidies that affect location decisions".[8] The paper cautions against trying to discipline investment incentives on the grounds that a degree of subsidised-based competition may produce efficiency gains. According to this line of argument, the presence of investment incentives ensure that the jurisdiction that expects the greatest economic benefits from a given investment project is free to secure it by topping the incentives of competing jurisdictions. However, as also noted by the paper, this finding is preconditioned on firms being mobile and incentives not discriminating on the basis of nationality. Against this background the paper advocates the use of generally available investment subsidies rather than particular FDI incentives.

2. Subsequent work on investment incentives

[CIME] A joint questionnaire exercise by the ***OECD and WAIPA Secretariats*** has assessed the degree to which developing countries compete for FDI by means of incentives, against each other and against the most highly

developed economies.[9] The paper concludes that while many developing countries engage in either proactive or defensive incentive strategies aimed at attracting FDI in competition with other locations, there are few cases of them being in direct competition with developed economies. Competition mostly occurs within geographic regions and where countries are on comparable levels of economic development, which limits the scope for direct competition between mature and developing economies. Moreover, the cases of particularly sharp competition for individual investment projects appear to be limited to a few economic sectors – notably car production. [Forthcoming on OECD website.]

A recent study by the ***OECD Development Centre*** focuses on the policy concerns (and potential benefits) that arise from cross-border or cross-jurisdictional incentives-based competition.[10] It develops a two-dimensional framework in which the discussion of potentially wasteful incentives is expanded to cover the international as well as the national dimension. The paper finds that competitive pressures between jurisdictions are in many cases a significant determinant of the generosity of investment incentive packages. However, it also observes that it is difficult to assess whether – or in what cases – the efficiency gains from competitive bidding outweigh the cost of such practices to the international system. Policy makers may nevertheless wish to put mechanisms in place to guard their jurisdictions from the possibility of sub-optimal outcomes. The paper develops a set of policy conclusions along two lines, by examining the contributions that policies of increased transparency and of a more formalised co-operation between jurisdictions can make toward minimising the downside risks.

A consultant paper prepared by **InSites Investment Counsellors** (parts of which were used as a starting point for the Committee's Checklist) addresses a range of issues related to investment incentives from a practitioner's viewpoint.[11] The paper reviews a large body of anecdotal evidence from some of the most highly developed OECD countries. It argues that an increasing number of investment projects put one large investor in a quasi-monopolistic position *vis-à-vis* a fragmented community of host locations. Moreover, it cites a large number of representatives and investors who consider that the scale of investment incentives is presently excessive and uses this in support of the argument that they (the incentives) have reached a level where they put the efficiency of capital allocation at risk. The paper furthermore proposes some cross-country approaches that could be applied to curb "harmful" FDI incentives. It recognises the usefulness of increased transparency in this respect, but argues that co-operation between jurisdictions probably needs to be taken further. In particular, the paper argues that policy makers should seek to agree on a "statement of basic principles" on international investment policy. It proposes a series of commitments regarding international

investment incentives, notably: the principle of transparency; the principle of non-discrimination (including national treatment and MFN); rolling back the offering of "the most harmful types of FDI incentives"; and refraining from using "harmful regulatory incentives".

A policy statement by ***BIAC*** makes public views held by members of the business community.[12] The statement observes that most companies would prefer a world without investment incentives where all competition between locations would be on the basis of the quality of enabling environments – *inter alia* because incentives imply a degree of discrimination among enterprises. The policy statement acknowledges a risk of fuelling an environment where FDI flows primarily to countries with "the deepest pockets" and warns again a situation in which smaller countries could be disadvantaged because of their inability to offset and absorb start-up losses from FDI. However, BIAC also notes that investor attraction depends on a complicated policy mosaic and that the focus of the discussion should therefore be much broader than the isolated issue of incentives. The following policy recommendations are proposed to national authorities as a means of safeguarding against negative outcomes. FDI incentives should be: generally available; non-discriminatory; transparent; in proportion to the expected benefits; clearly causal or closely linked with the actual investment; non-trade distorting; oriented toward long-term investment; temporary; and rooted in a coherent business model.

Notes

1. Magnus Blomström (2001), "The Economics of International Investment Incentives", Stockholm School of Economics [*www.oecd.org/pdf/M00037000/M00037957.pdf*]. Professor Blomström's work received financial support from the UK's Department for International Development.
2. Charles Oman (2000), "Policy Competition and Foreign Direct Investment", OECD Development Centre, Paris [*www.oecd.org/scripts/publications/bookshop/redirect.asp?pub=412000031P1*].
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4. Valpy Fitzgerald (2001), "Regulatory Investment Incentives", Finance and Trade Policy Research Centre, mimeo, Oxford University [*www.oecd.org/pdf/M00041000/M00041040.pdf*]. Dr. Fitzgerald's work received financial support from the UK's Department for International Development.
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6. "Environmental Issues in Policy-Based Competition for Investment: A Literature Review", mimeo [*www.olis.oecd.org/olis/2001doc.nsf/LinkTo/env-epoc-gsp(2001)11-final*].

7. "Regulation of Investment Incentives: The Impact of Trade Agreements", mimeo [not in the public domain].
8. "Competition Policy, Subsidies and State Aid", paper presented at the 2001 Best Practice Roundtable [*www.oecd.org/pdf/M00023000/M00023892.pdf*].
9. "Incentives-Based Competition for FDI in Developing Countries", mimeo [*www.oecd.org/pdf/M00041000/M00041036.pdf*].
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Chapter 4

Special Focus: Transparency and Investment

Among OECD countries and beyond a consensus is developing about the importance of public sector transparency. Above all, transparency is an essential ingredient for effective public policy and sustainable growth. In the specific context of international investment, transparency of the rules guiding cross-border transactions, including the provisions laid down in international investment treaties, is of obvious importance for investors. But the issues involved are much broader. The overall level of public sector transparency in host countries – whether linked with the rule of law, procedural fairness, integrity and public involvement in the political process – is recognised as one of the key factors that make investors, foreign and domestic alike, decide where, and whether, to invest. This special focus sheds light on these issues, drawing on the experiences from individual OECD member countries and in the context of international investment instruments. The articles are the following:

- *The benefits of public sector transparency for investment and beyond.*
- *Investment policy transparency in OECD countries.*
- *Foreign direct investment in professional services: making regulation more transparent.*

*The Benefits of Public Sector Transparency for Investment and Beyond**

1. Introduction

> ***(I)nstrumental freedoms contribute, directly or indirectly, to the overall freedom people have to live the way they would like to live... Transparency guarantees can be an important category of instrumental freedom. These guarantees have a clear instrumental role in preventing corruption, financial irresponsibility and underhand dealings.***
>
> ***Development as Freedom, Amartya Sen 1999 (pages 38, 40)***

Public sector transparency results from policies, institutions and practices that channel information in ways that improve understanding of public policy, enhance the effectiveness of political processes and reduce policy uncertainty. As the quote above from Nobel laureate Amartya Sen suggests, transparency is not an end in itself. It is an instrument for achieving other goals such as raising general welfare and promoting efficient and effective governments.

Practitioners in many policy fields recognise the importance of transparency.[1] It is an essential ingredient for effective political control and monitoring of the public sector. It is an important element of many trade and investment agreements. In particular, it is a core value of the OECD investment policy community and is highlighted in such instruments as the OECD Declaration on International Investment and Multinational Enterprises and the Codes of Liberalisation.

The attention paid to transparency in international policy making circles attests to the emerging consensus on its importance. The United Nation's Millennium Development Declaration and the Monterrey Consensus on Financing for Development both make prominent references to it. Transparency is a focus of preparatory work under the investment section of the Doha Development Agenda,[2] which also notes that developing countries

* This article was prepared by Kathryn Gordon, Principal Administrator, Capital Movements, International Investment and Services Division, OECD. It is based on a report initiated and approved by the Committee for International Investment and Multinational Enterprises in April 2003.

might benefit from capacity building to help them meet possible new transparency commitments.[3] In the context of post-Doha work in Geneva, the WTO Secretariat and delegations[4] have issued discussion papers on issues and options for possible approaches to transparency provisions in a multilateral framework on investment. According to a recent summary,[5] the focus of transparency discussions in the WTO is "not primarily on the benefits of transparency, but on the nature and the depth of transparency provisions and on the scope of their application (page 5)". The summary notes some countries' concerns about possible infringement of national sovereignty and about whether the "administrative costs of possible obligations could outweigh any benefits in terms of attracting foreign investors (page 8)".

This article argues that the most important benefits of transparency are linked, not only to attracting foreign investors, but to its instrumental role in enhancing the accountability of both the business and government sectors. Nevertheless, the importance that international investors attach to transparency when choosing where to invest has been well documented by business surveys.[6] Furthermore, recent OECD and IMF studies show that international investment flows are higher and that investments tend to be of higher quality in countries with more transparent policy environments (Box 1). Recent efforts by the international community seek to strengthen market pressures for pro-transparency reform by improving international investors' access to information about countries' transparency practices.[7] Thus, if countries want to attract more and higher quality investment, then fostering a fair, open and accountable policy environment should be a high priority.

The current article seeks to complement international discussions of transparency, both in the WTO and in other forums. Its contribution is to place the issue of transparency *vis-à-vis* the international investor in its more general public governance framework. The article draws on the considerable store of OECD analyses and data developed by the Public Management Directorate and by the Investment, Trade and other Committees. These analyses and data suggest that there are signs of progress, but also considerable scope for improving transparency in many policy fields and in virtually all countries. The international investment community's role – helping to define and protect international investors' rights to policy information – is part of this broader effort to enhance transparency.

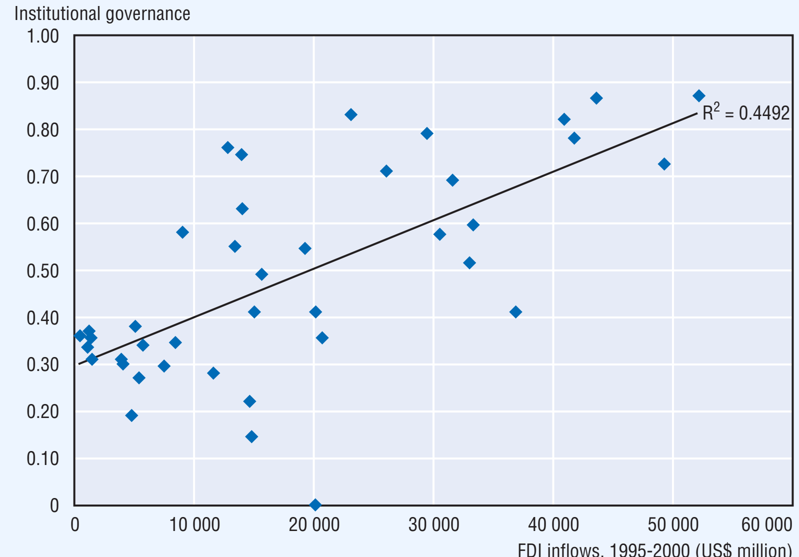
This article addresses the following questions:

- Why is public sector transparency an essential support for effective public policy and for successful economic development (in addition to being helpful for attracting foreign investment)?

Box 1. **Transparency and international investment**

Chapter 10 of *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs* reviews the evidence on the relationship between transparency and foreign investment flows. The report notes that transparency, by its nature, cannot be easily quantified, nor can it be isolated from other policies that influence FDI. The focus needs to be both on the nature of the rules applying to foreign investment and on the degree of transparency in their implementation. The report uses a measure of the quality of institutional governance, an index of qualitative evaluations the rule of law, the judicial system, enforcement, corruption, and shareholder and creditor rights. It plots this measure against FDI inflows. The overall relationship between the quality of governance and the level of inflows is clear and positive (see Figure) even though there are wide variations in inflows even for countries with similar institutional governance ratings (as one would expect given the large number of factors affecting investment decisions).

Figure. **The relationship between inward FDI and the quality of institutional governance**



Source: OECD 2002c, page 180.

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Box 1. **Transparency and international investment** *(cont.)*

Gelos and Wei (2002) also study the relationship between transparency and the behaviour of managers of emerging market funds). Using indices of both government and corporate transparency, they find that these funds holder fewer assets in less transparent markets. They also find that transparency reduces "herding" of fund managers' investment decisions. Herding is a theoretical concept describing the tendency of investors to make decisions based on what they see other investors doing. If found to exist in real markets, such behaviour could point (among other things) to imperfect distribution of information (that is, some investors are better informed than others). This implies that investment decisions are not being made on a fully informed basis and, therefore, that improved transparency could improve the quality of investment decisions.

- How is the concept of transparency used in various policy areas? How does the international investment policy community define the term?
- What is the role of the international investment community in promoting transparency in public policy? How does its role fit with the broader effort to enhance public sector transparency?
- What is known about current transparency policies and practices?
- What institutional and economic resources are needed to sustain transparent governments? What resources and capacities are needed to sustain transparent investment policies?
- Where might capacity building support greater transparency in the investment policies of developing countries? What are the limits to capacity building?

The article first reviews the role of public sector transparency in contributing to successful and equitable economic development (Section II). It then reviews various concepts of transparency and looks at how the concept used by the international investment policy community fits into broader thinking on transparency (Section III). It looks at what is needed to produce transparent public policies by drawing on several decades of OECD experience (Section IV). In Section V, obstacles to greater public sector transparency and approaches to capacity building are explored.

2. Transparency – A key input to effective governance and development

For many decades, economists have sought to shed light on the puzzle of economic development. Originally, the development debate focused on the

dynamics of macroeconomic or sectoral aggregates – income, capital accumulation, and employment. While continuing to acknowledge the importance of these aggregates, the debate now also encompasses broader concepts of economic, social and environmental welfare. Amartya Sen notes that successful development – development that gives people the freedom to "live the way they would like to live" – is underpinned by the respect of a wide range of rights.[8] These include economic rights (especially property rights), political freedoms, transparency guarantees and protective security. These rights provide instruments for development in that they facilitate the emergence of institutions (*e.g.* free press) or capabilities (*e.g.* right to participate in the political process) that improve the ability of people, acting singly or as a group, to raise their own welfare. Institutions of various types – economic, political and civil – have also become central to the way people think about economic development.[9] Governments play critical roles – both positive and negative – in the development process by providing (or failing to provide) basic services, including protection of rights and support for the development of a more advanced set of institutions.

2.1. Governments as facilitators of development

Governments' positive roles in the development process can be summarised as:

- *Helping society achieve its collective needs and meet its aspirations*. Governments help forge the views of diverse groups into policies that allow societies to meet their needs for co-ordination and co-operation. While assuming this positive role, governments engage in many activities (*e.g.* infrastructure development, regulation, social insurance, taxation and subsidisation, prudential supervision and contract and law enforcement).
- *Upholding and adapting some of the formal rules systems that underpin successful development*. Economic development is associated with progressively greater reliance on formal rules and a somewhat reduced economic role for other informal rules systems such as those observed in family businesses. Governments play a critical and pervasive role in this formalisation process.[10]

2.2. Governments as impediments to development

There is, however, a less flattering perspective on government activity. OECD assessments of policy experience[11] show that governments – through over-bearing regulation or taxation, waste and outright corruption – can be a serious impediment to economic development. If mismanaged, governments can act as brakes on development. Large volumes of resources are channelled through governments. Tax revenues represented, on average, 37 per cent of

OECD GDP in 2000. Governments also affect resource allocation through such policies as procurement, competition, state-owned enterprise, subsidies, infrastructure development, regulation, and tax expenditures. These create high stakes for political rent seeking. If not subject to transparency and accountability, governments can condone or promote corruption, stifle entrepreneurship, innovation and market adjustment and fail to achieve social, environmental and economic goals.

To varying degrees, these problems are endemic to public sectors everywhere. They arise from three sources. First, government outputs can be inherently complex or difficult to define and inputs and costs may not be easily measurable. Therefore, it can be difficult to assess public sector efficiency. Second, public policies often create asymmetries in incentives to participate in and to monitor the political processes that lead to their creation. This creates a tendency toward "concentrated benefits" in government activity (OECD, 2002a). Third, government officials' incentives cannot always be perfectly aligned with the public interest, causing problems that range from "slacking off" to outright corruption.

2.3. Transparency and the performance of the public sector

Transparency helps societies to enhance their governments' positive contributions while also helping to resolve the problems inherent in government activity. Information about policy is an input for *ex ante* political control of the public sector, for day-to-day responses to policy (*e.g.* for complying with law or making economic adjustments to policy incentives such as taxes) and for *ex post* monitoring and evaluation. It is therefore an essential component of appropriate public governance.

Transparency guarantees involve rights to certain types of information. These rights help prevent potential abuses arising from information asymmetry and permit individuals or organisations to respond to information through political, civil or economic activity. The international investment community is concerned with a small, but important part of this overall framework of rights – the rights of international investors to certain kinds of policy information. Its activities are part of and complementary to larger efforts to define these rights, enhance transparency and improve public governance.

3. The meaning of public sector transparency

There is no commonly agreed definition of transparency. Box 2 presents concepts taken from various sources – the draft Multilateral Agreement on Investment (MAI), the International Monetary Fund's Fiscal Transparency Guidelines, a statement by APEC leaders, the OECD regulatory governance

Box 2. **Definitions of transparency**

- *Political science dictionary* (Brewer's Politics): "openness to the public gaze" (in Florini, 1999).
- *Business consultancy*. "the existence of clear, accurate, formal, easily discernible and widely accepted practices" (PriceWaterhouseCoopers 2001).
- *OECD Public Management*. "The term "transparency' means different things to different groups [of regulators]. Concepts range from simple notification to the public that regulatory decisions have been taken to controls on administrative discretion and corruption, better organisation of the legal system through codification and central registration, the use of public consultation and regulatory impact analysis and actively participatory approaches to decisions making." OECD (2002a)
- *International Monetary Fund*. … [b]eing open to the public about the structure and functions of government, fiscal policy intentions, public sector accounts and fiscal projections" IMF (1998).
- *Draft Multilateral Agreement on Investment*: "Each Contracting Party shall promptly publish, or otherwise make publicly available, its laws, regulations, procedures and administrative rules and judicial decisions of general application as well as international agreements which may affect the operation of the Agreement. Where a Contracting Party establishes policies which are not expressed in laws or regulations or by other means listed in this paragraph but which may affect the operation of the Agreement, that Contracting party shall promptly publish them or otherwise make them publicly available." April 1998 draft text. *www.oecd.org/daf/mai/*
- *APEC Leaders' Statement to Implement APEC Transparency Standards (October 2002)*: Transparency "is a basic principle underlying trade liberalisation and facilitation, where removal of barriers to trade is in large part only meaningful to the extent that the members of the public know what laws, regulations, procedures and administrative ruling affect their interests, can participate in their development.. and can request review of their application under domestic law… In monetary and fiscal policies, [transparency] ensures the accountability and integrity of central banks and financial agencies and provides the public with needed economic, financial and capital markets data.…
- *Monetary policy practitioners*: "The communication of policymakers' intentions with a view to enhancing their credibility." (Friedman 2002); "The communication of policymakers' intentions" (King 2000).
- *World Trade Organisation*. Ensuring "transparency" in international commercial treaties typically involves three core requirements: 1) to make information on relevant laws, regulations and other policies publicly available. 2) to notify interested parties of relevant laws and regulations and changes to them; and 3) to ensure that laws and regulations are administered in a uniform, impartial and reasonable manner. WTO (2002).

project, two monetary policy theorists, the World Trade Organisation and a glossary of political science terms. Some concepts focus on basic elements of public sector transparency – for example, the public and timely availability of information about legislation, regulation and other public measures that affect business behaviour. Others deal with the broader objective of transparency – governments' "openness to the public gaze" or successful "communication of policymakers' intentions".

The discussion that follows is based on this distinction. At one level, the meaning of transparency (and the measures that bring it about) is basic and non-controversial. It involves core measures for informing the public about policy and these measures are of universal relevance. The broader view of transparency relating to successful communication about policy requires consideration of national institutions, values, preferences and ways of doing things.

3.1. Core transparency measures and international investment agreements

Access to information about public sector activity – and the scope, accuracy and timeliness of such information – is the thread that links all concepts of public sector transparency. It can be thought of as the inner kernel from which all other concepts and practices grow. It is so fundamental as to be almost inseparable from basic fiscal, legislative and regulatory functions. For instance, if governments are to make rules effective, then the individuals bound by those rules must be aware of them. Several international best practice guidelines pertaining to this concept have emerged.[12]

The OECD Secretariat has examined the treatment of transparency in the texts of several international, regional and bilateral investment agreements as well as in the draft Multilateral Agreement on Investment (Table 1). The table is based on an evaluation of the text of the agreements. It shows that the agreements focus on fairly basic measures for making policy information available to private and state actors.

Based on this review, the following list of core transparency measures for the international investment community can be derived:

- Provision of information on policies of interest to international investors. The list of policy areas covered by these agreements is long (Table 1 shows only selected items). It includes legislation, administrative rulings, judicial decisions, exceptions to national treatment and most favoured nation status, procedures for applying for authorisations, administrative practices, privatisation and monopolies.
- Clear definitions of the limits of transparency obligations (security is the most commonly cited exception); and

Table 1. **Transparency provisions mentioned in international agreements dealing with investment**[1]

Name of Agreement	Draft MAI	OECD Declaration	GATS	NAFTA	German model BIT	US model BIT	APEC standard[2]	OECD Codes
Selected objects subject to specific transparency provisions[3]								
Laws, regulations, international agreements, administrative practices/rulings, judicial decisions and/or policies, etc.	X	X	X	X		X	X	
Exceptions to most favoured nation			X	X		X		X
Exceptions to national treatment	X	X	X	X		X		X
Investment incentives	X	X		X				
Procedures for applying for authorisations/permits/ licenses	X		X	X				
Monopolies and concessions	X		X	X				
Privatisation	X							
Expropriation and compensation	X			X	X	X		
Selected mechanisms in support of transparency								
Timely publication of measures	X		X	X		X	X	
Establish enquiry points		X	X	X				
Peer review		X						X
Notification and/or reporting to other Parties and/or IOs	X	X	X	X			X	X
Prior consultation or other forms of participation (*e.g.* opportunities for comment)				X[4]			X	
Party/IO can request consultations	X	X	X	X		X		X
Recourse for private actors[5] (conciliation, mediation, arbitration, courts, etc.)	X	X	X	X	X	X	X	

Table 1. **Transparency provisions mentioned in international agreements dealing with investment**[1] *(cont.)*

Name of Agreement	Draft MAI	OECD Declaration	GATS	NAFTA	German model BIT	US model BIT	APEC standard[2]	OECD Codes
Selected exceptions/ qualifications to transparency obligations[6]								
Protection of confidential information and/or commercial interests	X		X	X			X	
Security and emergencies	X		X	X		X		X
Public order/public morals/law enforcement	X		X	X			X	X
Pursuit of monetary or exchange rate policies	X							

1. This table is based on the text of the agreements and, in particular, on the transparency obligations they contain. Further interpretation and clarification of the agreements by the responsible international body, and the manner in which the agreements are applied on a day to day basis are not reflected in the table. Nevertheless, these may have a significant impact on how the transparency provisions are construed and on whether the provisions of the agreement are applied in a transparent manner.
2. Leaders' Statement to Implement APEC Transparency Standards.
3. Some agreements do not cover some of the selected objects *per se*. As a result, they are not shown as having specific transparency provisions in the area concerned.
4. Chapter on financial services.
5. "Recourse for private actors" refers to conciliation, mediation and arbitration as transparency measures *per se*; it does not refer to conciliation or mediation with respect to the transparency provisions of the agreement.
6. In some agreements, the exception/qualification to transparency obligations derives from more general exceptions/qualifications to the obligations in the agreements.

Source: Compiled by OECD Secretariat.

- Ensuring that policy information is accessible to international investors and to other governments – for example, by notifying the parties of changes to measures, by establishing national enquiry points, specialised publications or registers and web sites.

Although the coverage and scope of investment agreements vary, they all focus on what can be considered core transparency measures. They involve basic commitments to be transparent in policy areas that affect international business. They amount to a commitment that law will be enacted and enforced in an orderly and fair manner.

Other considerations include:

- *Arrangements for state-to-state information flows* include formal notification procedures and spontaneous responses to request for information from other parties to the agreement. A distinctive feature of the OECD Declaration and the OECD Codes is their use of peer reviews to enhance transparency and to improve policy practice.[13]

- *Prior notification and comment*. The paper summarising recent transparency discussions in the WTO notes states that "there was no common view on the applicability of prior notification and comment requirements." Section IV of this paper suggests that requirements of this nature reflect emerging best practices (as revealed in the country regulatory reform reviews).
- *Nature of commitments– detailed obligations or broad principles*. Some of the instruments contain commitments on transparency that are both comprehensive and detailed. For example, the MAI would have committed countries to a relatively detailed list of obligations. In contrast, other instruments are framed as broad principles. An example is the OECD Declaration (although its associated peer reviews produce investment policy information that is both comprehensive and detailed).
- *Provision of recourse for private actors*. Many of the instruments reviewed (in various ways) recourse for private actors through such facilities as conciliation, mediation and arbitration. This goes beyond investors' rights to access to information – it promotes their right to act on this information.

Although the agreements differ in how they frame transparency commitments, they tend to deal with a range of measures that are of universal relevance. That is, every formal, organised, democratic government needs to be able to communicate its policy settings, to define the limits to rights to access to information and to provide means of communicating this information and of ensuring that it can be acted on.

3.2. Transparency as effective communication about public policy

While these practices are of near universal relevance, they involve a narrow view of transparency. They focus on concrete measures that promote and protect rights to public sector information. A broader view is that transparency is what results from successful two-way communication about policy between governments and other interested parties[14]. Communication about policy poses some difficult challenges: How can policymakers communicate their "intentions" to what might be a diverse group of actors – for example, sophisticated international investors, illiterate peasants, voters? What is their incentive for doing so? Why would non-governmental actors believe what governments say about their announced policies? What institutions facilitate successful communication between governments and the people interested in their policies?

Communicating about public policy involves both "senders" and "receivers" of information as well as transmission channels (paper publications, websites, public hearings etc.). It can happen that communication, for some reason, is not successful. Policy information may not be presented in an understandable way to particular audiences or the transmission channels used may not reach them. Strategic considerations

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may come into play (*e.g.* deliberate distortions), implying that honesty, reputation, credibility are also inputs to transparency.

Transparency in this broad sense is closely linked to national institutions, cultures and ways of doing things. The country reviews undertaken by the OECD regulatory reform project describe many instances of this. The review of Denmark (OECD 2000a) shows how history, national values and globalisation have interacted to create a dual regulatory structure. This consists of, on one hand, a codified, transparent system whose emergence is due largely by the pressures of globalisation and of regional disciplines. This coexists with a second system – relying mainly on informal agreements and private contracting and relatively little on formal law – that reflects a preference for (and ability to achieve) consensus-based control of business and individual behaviour. This contrasts with the regulatory style described in the review of the United States (OECD 1999). The review suggests that the country's "historic value of economic liberty" has lead to regulatory style involving "a legalistic and adversarial environment based on open and transparent decision-making, on strict separation between public and private actions and competitive neutrality between market actors. These characteristics support market entry and private risk taking." The review also notes that regulation reflects other threads in American society such as the search for balance between federal powers and states rights, constitutional issues of individual property rights *versus* collective rights and institutional struggles among the powers of the Congress, the President and the Executive Branch (page 17).

Taken as whole, the OECD regulatory reform reviews show that public sector transparency is a complex phenomenon that reflects national preferences and institutions. It cannot be said to exist simply because core transparency measures (*e.g.* timely publication of law) are in place (though these are important).

Other factors are also relevant when trying to render public policy more transparent:

- *Policy complexity and choice of audiences.* Policies are often complex and information about it has to be condensed, simplified and put into context in order to make it comprehensible. The OECD regulatory reform project, for example, calls for "plain language drafting". In some areas, however, the policies to be described are inherently complex and involve specialised expertise. A policy that is understandable and transparent to an audience of specialists, may not be to other audiences.
- *Codification and the transparency of administration and enforcement.* The business activities influenced by public policy are also complex. For example, prudential regulation in banking has to account for financial institutions' activities in numerous markets and geographical locations. Complexity

means that policy makers must make choices about how they frame law and regulation – should they set forth broad principles and let businesses decide what these principles mean for their behaviour or should they opt for more detailed descriptions of legal and illegal behaviours? These choices influence approaches to transparency. If legislative requirements are framed as broad principles, legal codes will tend to be short and easily understandable. Yet, in this case, approaches to administration and enforcement determine much of a law's substance. For this reason, it is important that administration and enforcement also be transparent.

- *Reputation and credibility.* Monetary and fiscal policy practitioners have a long-standing interest in the issue of policy credibility – that is, the extent to which non-government actors believe governments when they announce policies. This, in turn, influences how actors respond to policy. For example, laws that people believe will not be enforced have different impacts than laws backed up by credible enforcement commitments. There are many reasons why a government's policy announcements might not be credible. One of them is that governments may lack the means to carry out announced plans. Another is that, for various reasons (*e.g.* political gaming), they may have an interest in changing plans abruptly or not making good on policy "promises". Governments that engage frequently in such behaviours lose reputation and credibility. Without these, formal measures for transparency will not have their intended effects. That is, governments will not be able to use them to enhance public understanding of policy content, thrust and objectives.
- *Transparency and rights.* Public sector activity can involve thousands of programmes, employ tens of thousands of civil servants operating in thousands of locations and can affect millions of people in diverse and evolving ways. Thus, the transparency framework needs to create two-way information flows in a decentralised way, as the need arises. For example, a person who has been asked for bribe by a public official should have the means to make this information available to the government without fearing for his or her welfare. This is why respect of basic political, civil, social and labour rights is an integral part of the general transparency framework. Investor rights are an element of this broader rights framework.
- *Insiders versus outsiders.* Since transparency involves national institutions, ways of communicating and even languages, "insiders" – people who are native to a particular policy environment – might be more comfortable with national transparency arrangements than "outsiders". This consideration is of particular interest to the investment policy community, since it implies that, in order for the principle of non-discrimination to apply in matters of transparency, governments may have to make special efforts to communicate effectively with "outsiders" – including international investors.

4. OECD experiences with public sector transparency

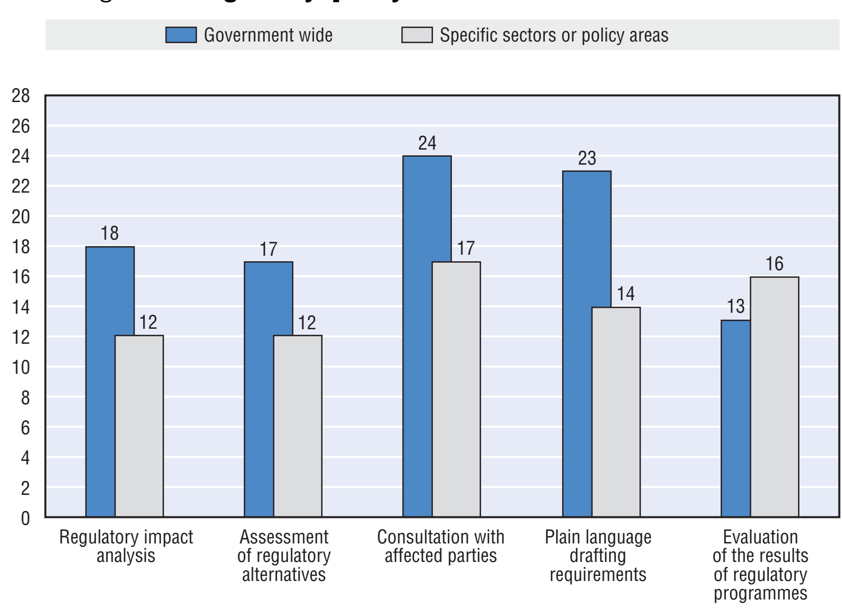
This section reviews what is known about transparency practices and performance. It suggests that, despite signs of progress, there is still considerable room for improving transparency policies and practices.

The OECD long-standing horizontal project on regulatory reform emphasises the importance of transparency for effective regulation. It also surveyed transparency measures in the OECD area. The synthesis report on this work (OECD 2002a) suggests that the trend in the OECD area has been toward heightened transparency. Figures 1 and 2 show the main transparency measures surveyed in the project's database on regulatory practices based on surveys of 26 countries conducted in 1998 and 2000. These include codification of law, publication of registers of law, linking enforceability to availability on the register, access via Internet and plain language drafting. The report notes that this trend has been reinforced by a widening set of international disciplines such as the OECD investment instruments and the GATS.

Some important elements of regulatory transparency, as practised in the OECD, are:

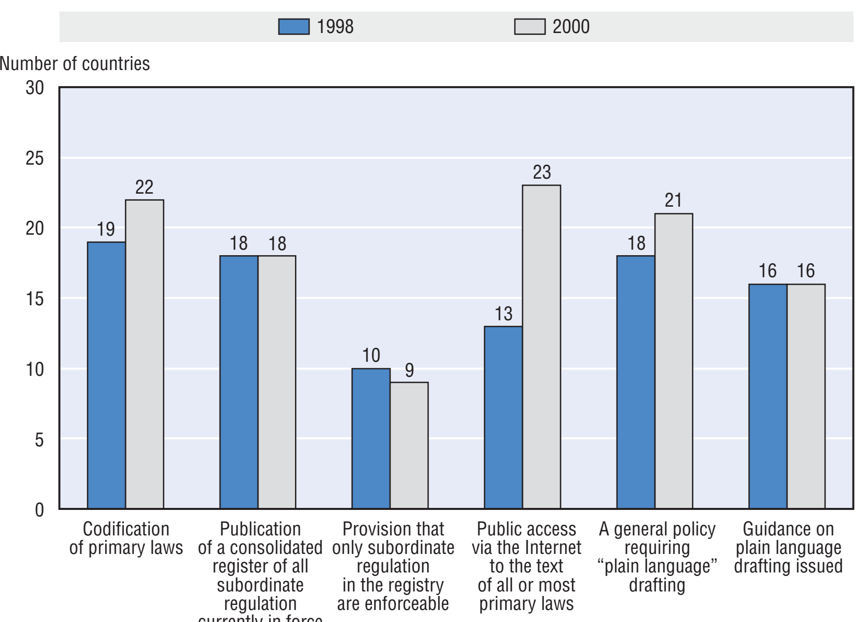
- *Consultation with interested parties*. The widespread use of consultations reflects a growing recognition that effective rules cannot rely solely on command and control – the individuals and organisations covered by rules need to be recruited as partners in their implementation. Consultation is the first phase of this recruitment process. It can also generate information and ideas that would not otherwise be available to public officials. Consultation mechanisms are becoming more standardised and systematic. This enhances effective access by improving predictability and outside awareness of consultation opportunities. There is a trend toward adapting forms of consultation to the stage in the regulatory process. Consultation tends to start earlier in the policy making process, is conducted in several stages and employs different mechanisms at different times. Problems have been noted as well. For example, consultation fatigue – where some organisations are overwhelmed by the volume of material on which their views are requested – has been noted in several countries.
- *Legislative simplification and codification*. There is increased use of legislative codification and restatement of laws and regulations to enhance clarity and identify and eliminate inconsistency.
- *Plain language drafting*. Twenty-three countries require the use of "plain language drafting" of laws and regulation. Sixteen countries issue guidance materials and/or offer training programmes to help with clearer drafting.
- *Registers of existing and proposed regulation*. The adoption of centralised registers of laws and regulations enhances accessibility. Eighteen countries stated in end-2000 that they published a consolidated register of all

Figure 1. **Regulatory quality tools used in OECD countries**



Source: OECD (2002a), PUMA.

Figure 2. **Measures used to communicate regulations**



Source: OECD, Public Management, Regulatory Database.

subordinate regulations currently in force and nine of these provided that enforceability depended on inclusion in the register. Many countries now also commit to publication of future regulatory plans.

- *Electronic dissemination of regulatory material*. Three quarters of OECD countries now make most or all primary legislation available via the Internet.
- *Clear definition of the limits of transparency requirements* and a presumption in favour of transparency are also important elements of transparent policy.

According to the synthesis report, "performance is still far from satisfactory" (OECD 2002a, page 41). Table 2 summarises the problems that were identified in the course of in-depth regulatory reviews of 12 countries. All twelve countries have problems with legal texts that are difficult to understand and with overly complex regulatory structures. Biased participation in public consultation is noted for 8 countries and a tendency to exclude less powerful groups from consultation is cited for 4 countries. Other problems include lack of systematic policy analysis (called regulatory impact analysis – RIA – in the report) as a tool for improving the quality of consultations and a lack of clear standards in licensing and concessions (7 countries).

The OECD regulatory reform project has provided a detailed look at transparency practices and problems within the OECD area. Such comparative data and peer reviews are not widely available on a global scale. However, the global transparency data that does exist suggest that the finding that there is wide scope for transparency-enhancing reform in the OECD holds for other regions as well. Figure 3 presents comparative data on three indices – the Freedom House index of political and civil rights, the Corruption Perceptions Index based on a survey by Transparency International and the Opacity Index (also based on a survey). An average is taken for each transparency measure, based on the bottom 15 countries in terms of income (real GDP per capita) and the top 15 countries. The data show that the transparency performance of the higher income countries is better than the lower income countries. Although the relations of cause and effect underlying this finding are undoubtedly complex, the data do suggest that lower income countries might also benefit from further efforts in this area.

5. Addressing the obstacles to reform

The growing consensus in international circles about the importance of transparency does not imply that transparency-enhancing reforms will be easy to enact and implement. In recent WTO discussions of transparency, developing countries emphasised that transparency requirement should not be unduly burdensome.[15] The Doha Declaration notes that capacity building would help developing countries to implement possible new transparency obligations and approaches to capacity building.[16] OECD experience suggests

Table 2. **Regulatory transparency problems in 12 OECD countries**

Transparency problem	OECD recommendation	No. of countries with problem
Some form of public consultation is used when developing new regulations, but not systematically and with no minimum standards of access. Participation biased or unclear.	Adopt minimum standards, with clear rules of the game, procedures, and participation criteria, applicable to all organs with regulatory powers. Use "notice and comment" as a safeguard against regulatory capture. Reduce use of "informal" consultations with selected partners.	8
A systemic tendency to exclude less organised or powerful groups from consultation, such as consumer interests or new market entrants	Supplement existing consultation approaches with targeted approaches for affected groups. Include "outsider" groups, such as consumers and SMEs, in formal consultation procedures. Open advisory bodies to all interested persons. Take care that new approaches such as Internet are not biased against small businesses and less affluent parts of civil society.	4
Regulatory reform programme and strategy are not transparent to affected groups	Develop coherent and transparent reform plans, and consult with major affected interests in their development	5
Information on existing regulations not easily accessible (particularly for SMEs and foreign traders and investors)	Creation of centralised registries of rules and formalities with positive security, use one-stop shops, use information technologies to provide faster and cheaper access to regulations.	5
Legal text difficult to understand	Adopt principle of plain language drafting	12
Complexity in the structure of regulatory regimes	Codification and rationalisation of laws	12
National-subnational interface – more co-ordination and communication needed on interactions	Establish clearer competencies between levels of government; exchange information to avoid duplication	3
RIA is never or not always used in public consultation	Integrate RIA at an early stage of public consultation	9
Inadequate use of communications technologies	Use Internet more frequently in making drafts and final rules available as a consultation mechanism	6
Lack of transparency in government procurement	Adopt explicit standards and procedures for decision-making	3
Lack of transparency in ministerial mandates and roles of regulators	Clarify responsibilities between regulators	3
Regulatory powers delegated to non-governmental bodies such as self-regulatory bodies without transparency requirements	Develop guidelines on the use of regulatory powers by non-governmental bodies, and extend all transparency requirements to them	2
Too much administrative discretion in applying regulations	Strengthen administrative procedures and accountability mechanisms. Eliminate use of informal regulations such as administrative guidance and instructions.	4
Lack of transparency at regional, state, and local levels	Work to improve regulatory transparency at regional and local levels	8

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Table 2. **Regulatory transparency problems in 12 OECD countries** *(cont.)*

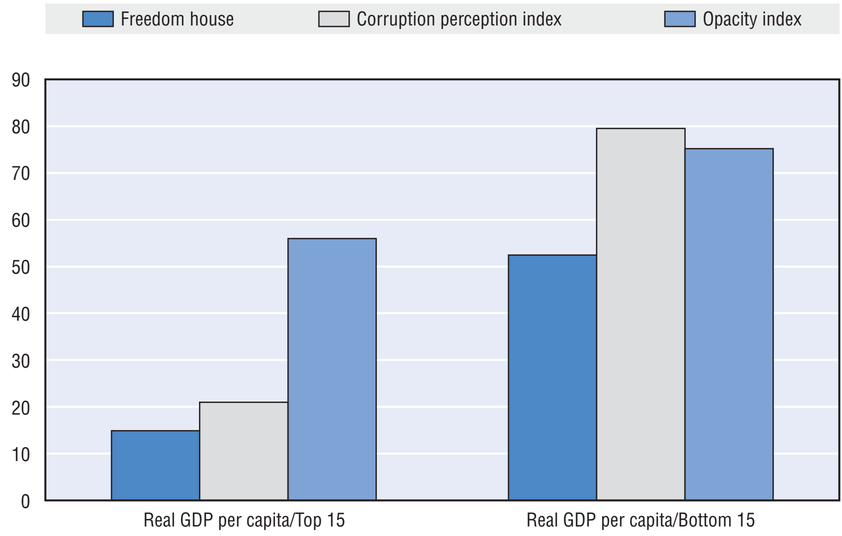
Transparency problem	OECD recommendation	No. of countries with problem
Inadequate use of international standards	Encourage the use of international standards government-wide, and track the use of uniquely national standards	4
Lack of clear standards in licensing and concessions decisions, such as in telecommunications	Reduce the use of concessions and licences to the extent possible by moving to generalised regulation, announce clear criteria for decisions on concessions and licenses, use public consultation for changes in existing licenses and concessions	7
Decisions of independent regulators not transparent enough	Apply RIA to independent regulators, ensure that independent regulators also use public consultation processes with regulated and user groups	5

Source: OECD 2002a.

that all countries – developed and less developed – could benefit from assistance, as the obstacles to reform can be sizeable. The difficulties stem from three areas:

- *Politics*. The main obstacles to transparency-enhancing reform are political. Attempting to overcome the natural political dynamic in favour of "concentrated benefits" is an ongoing struggle for all political systems. Lack of transparency also shields government officials from accountability. Thus,

Figure 3. **Indexes of non-transparency by income group**



Note: Scale of corruption perception index is reversed and multiplied by 10. Freedom House index is scaled and multiplied by 100.

Source: Complied by OECD.

many actors – both inside and outside the public sector – can have a stake in non-transparent practices. It is for this reason that, despite the broad apparent agreement in principle about their benefits, actual implementation of transparency-enhancing reforms are likely to involve painful shifts in the way policies are made and implemented, especially in countries with highly opaque policy environments. The difficulty will be to develop the political momentum for pro-transparency reform and to prevent backsliding. Transparency commitments in international investment agreements and international peer pressure can help countries face this difficulty. In this sense, transparency disciplines pose similar challenges for the developing and the developed worlds and are equally valuable for both.

- *Institutions.* All countries' institutional structures make certain transparency measures possible and make others more difficult. For example, it would probably not be possible to implement Danish-style transparency practices for labour standards in the United States – the necessary formal and informal institutions do not exist there. On the other hand, international agreements tend to focus on core transparency measures. These are the starting points for other communication processes that are closely linked to national institutions which usually evolve slowly and incrementally. The challenge for the international investment community is to create the conditions that help countries move forward on core measures, while also working with and enhancing the distinctive national characteristics of transparency practices.
- *Technological, financial and human resources.* Transparency requires access to resources and entails administrative costs. Although the core transparency measures discussed earlier tend to be straightforward, they involve the creation of registers, web-sites, the development of "plain language" texts and other mechanisms for making the language of legal and regulatory codes accessible to target audiences. For foreigners, translation of the host country's texts into relevant foreign languages would also require resources and entail costs. If new transparency disciplines are on the horizon, there may be a need for capacity building and technical assistance designed to supply or develop the necessary human resources and technology in a more cost-effective way.

There are many options for using international agreements as a means of promoting transparency-oriented reform. A report to the Trade Committee (Working Party of the Trade Committee 2002) describes a "continuum of options, from binding disciplines covering all sectors to "best endeavours' commitments adopted in full or in part for some sectors only (page 6)." The report notes that the formulation of such disciplines will influence the degree to which the obstacles identified above will come into play. For example, broad cross-sectoral approaches to transparency commitments make it more difficult for sectoral

special interests to block reform – they may therefore reduce political obstacles. On the other hand, more flexible or prioritised approaches might allow countries to circumvent institutional or resource obstacles more readily.

6. Conclusions

Irrespective of whether new international disciplines are on the horizon, the challenge of enhancing and maintaining public sector transparency is an ongoing task for all countries. The preceding discussion suggests that transparent public policy is both straightforward (the people covered by policies must know about them) and extremely subtle (resulting from successful communication between governments and millions of diverse actors).

In this context, the challenges for the international community would appear to be to:

- *Promote core transparency measures*. These measures are already the subjects of the investment provisions of existing international agreements. They are an integral part of good public governance and are of universal relevance.
- *Understand the distinctive features of national transparency practices and, where possible, help to make them more effective*. National specificities in transparency arrangements are an important and deeply entrenched feature of the economic landscape. They will influence how individual countries approach international negotiations on transparency and how transparency disciplines will be enacted in and will influence the domestic policy environment. Understanding these national differences will therefore facilitate international discussions. In addition, certain of these national arrangements could benefit from international experience sharing (*e.g.* via peer reviews) so as to enhance their strengths and minimise their weaknesses.
- *Make the case that improving international investors' access to information complement broader efforts to improve public sector transparency and effectiveness*. Investors' rights to information are one part of the framework of rights to access and to use policy information. Efforts to promote investors' access to information are the international investment community's contribution to the broader effort to improve these frameworks everywhere.

Notes

1. In order to improve its focus on public sector transparency, this paper sets aside the important issue of transparency in the private sector. This issue is the subject of ongoing discussions in the CIME in the context of the follow-up procedures of the OECD Guidelines for Multinational Enterprises. A review of private sector transparency practices may be found in *Corporate Responsibility: Private Initiatives and Public Goals*. OECD 2001.

2. Paragraph 22 of the Doha Declaration Development (WT/MIN(01)/DEC/1).states: *In the period until the Fifth Session, further work in the Working Group on the Relationship Between Trade and Investment will focus on the clarification of: scope and definition; transparency; non-discrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards; consultation and the settlement of disputes between members. Any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest. The special development, trade and financial needs of developing and least-developed countries should be taken into account as an integral part of any framework, which should enable members to undertake obligations and commitments commensurate with their individual needs and circumstances. Due regard should be paid to other relevant WTO provisions. Account should be taken, as appropriate, of existing bilateral and regional arrangements on investment.*
3. See paragraphs 20 and 21 of the Doha Declaration on Development (WT/MIN(01)/DEC/1).
4. The European Communities (WT/WGTI/W/110), Japan (WT/WGTI/W/112) and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu (WT/WGTI/W/129) contributed written comments.
5. See the "Report (2002) of the Working Group on the Relationship between Trade and Investment". WT/WGTI/6. December 19, 2002.
6. The communication from the European Community and its member States (WT/WGTI/W/110) "Concept Paper on Transparency" states: "*The TN SOFRES Business Survey conducted for the EC Commission in April 2000 among some of the biggest EU companies showed that lack of transparency on local legislation and rules was considered the most frequent hindrance to investment by 71 per cent of the companies*." Likewise, the communication from Japan (WT/WGTI/W112) noted that a survey of Japanese companies operating overseas placed lack of transparency at the top of the list of barriers to foreign direct investment.
7. For example, the International Monetary Fund and the World Bank, at the request of a country, may produce and publish a report on the extent to which the country observes 12 internationally recognised standards and codes. This is called a "Report on the Observance of Standards and Codes" (ROSC). Many of the standards and codes cover, directly or indirectly, policies and practices relevant for both public and private sector transparency. In addition to being of direct relevance to the work of the IMF and World Bank, these reports are also published in order to provide information useful to "the private sector (including rating agencies) for risk assessment." (*www.imf.org/external/np/rosc/rosc.asp*).
8. See Sen (1999). Coming out of a social choice perspective, Sen's applied work focuses on the economics of gender inequality, deprivation and famine. His more recent work focuses on the various social, economic and institutional features that determine whether or not people develop the "capabilities" to lead the kind of lives they wish to lead – transparency and information play a major role in this work.
9. See North (1990).
10. Some of these rules systems facilitate the emergence of more advanced business organisations and more complex forms of contracting (*e.g.* limited liability companies, franchises, multi-divisional companies, and investment in intangible assets). For example, laws underpinning limited liability are essential parts of the rules framework that supports advanced market economies. Governments –

broadly defined to include legislative, judicial and political processes – were the main organisational channels through which this path breaking innovation was developed. Jepperson and Myer (1991).

11. See OECD (2002a).
12. See, for example, OECD 2002a, page 24 for recommendations on regulatory governance, including on regulatory transparency. See also the APEC Leaders' Statement to Implement APEC Transparency Standards (2002) and the International Monetary Fund Code of Good Practices on Fiscal Transparency (1998) and the OECD Best Practices for Budget Transparency (OECD 2000b).
13. Recent reviews of international investment policies include the OECD Reviews of Foreign Direct Investment for Estonia (OECD 2001a), Lithuania (OECD 2001b), Israel (OECD 2002e) and Slovenia (OECD 2002f). These reviews are part of the process of adherence to the OECD Declaration on International Investment and Multinational Enterprises. Peer reviews are also conducted under the legally binding Codes of Liberalisation of Capital Movements and of Current Invisible Operations. Recent reviews under the Codes have focused on new members to the OECD and on particular sectors (such as telecommunications).
14. See Winkler (2000) for a discussion of the transparency of monetary policy, viewed as a result of communication.
15. From a WTO press release describing the discussions of transparency at the April 18-19, 2002 meeting of the Working Group on the Relationship between Trade and Investment.
16. Paragraph 21 of the Ministerial Declaration adopted at Doha states the following about capacity building: *We recognise the needs of developing and least-developed countries for enhanced support for technical assistance and capacity building in this area, including policy analysis and development so that they may better evaluate the implications of closer multilateral co-operation for their development policies and objectives and human and institutional development. To this end, we shall work in co-operation with other relevant … organisations… to provide strengthened and adequately resourced assistance to respond to these needs.*

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*Investment Policy Transparency in OECD Countries**

1. The meaning of transparency

As noted in the previous article, public sector transparency is fundamentally about effective communication on public policy between governments, business and other civil society stakeholders. In the international investment policy community, it is primarily understood as making relevant laws and regulations publicly available, notifying concerned parties when laws change and ensuring uniform administration and application. For an increasingly larger number of practitioners, it may also involve offering concerned parties the opportunity to comment on new laws and regulations, communicating the policy objectives of proposed changes, allowing time for public review and providing a means to communicate with relevant authorities.[1] In addition, it is broadly acknowledged that international collaborative efforts have a complementary role to play in disseminating information, defining common standards and providing peer review support and capacity building for more transparency. Transparency has been identified as a key issue for the post-Doha[2] and Monterrey[3] agendas on international investment.

Of course, transparency alone is not sufficient to ensure a favourable regulatory environment if the underlying laws and regulations are inadequate or unpredictable. However, the ability of investors to fully understand the regulatory environment in which they are operating as well as having a voice in regulatory decision-making remains critical to their operations. This is true for domestic and foreign investors but particularly relevant to foreign investors who may be confronted abroad not only with different regulatory content, but with a differing regulatory culture and administrative frameworks. Only when they have access to complete and transparent information, can they exploit all the possibilities foreign markets may offer. Indeed, transparent systems of rules and regulations can act as an important incentive to foreign investors. The Business and Industry Advisory Committee

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to the OECD (BIAC) has recently put the benefits of transparency to be as follows: "From a business point of view transparency reduces risks and uncertainties, promotes patient investment, reduces opportunities for bribery and corruption, helps unveil hidden investment barriers and draws the line between genuine and less genuine policy objectives, assists investors dealing with "thin' rules, discourages 'conflicting requirements' situations between home country or host country, contributes to the playing field among firms and facilitates sustainable development".

Considerable efforts have been deployed by the OECD in the recent past to assess the quality and possible areas for improvement of OECD regulatory frameworks; and transparency has been one of the main areas of attention. The multidisciplinary OECD Regulatory Reform Programme identified last year a number of emerging "best OECD practices" for regulatory transparency.[4] Other related work has examined the role of the state in good governance and accountability[5] and the contribution of new communications technologies to better government (the so called e-government).[6] Early this year the OECD Trade Directorate released a documented analysis of the regulatory policies and practices favouring market openness among 16 OECD countries, including on transparency and openness of decision-making.[7]

Taking advantage of these efforts, the OECD Committee on International Investment and Multinational Enterprises (CIME) has also recently embarked on the development of an FDI-focussed and outreach-relevant inventory of transparency measures in the 38 countries which have adhered to the OECD Declaration on International Investment and Multinational Enterprises.[8] This endeavour covers the three main clusters of issues allegedly at the core of international investment transparency policy, namely *a) publication and notification*, *b) prior notification and consultation* and *c) procedural transparency*. Beyond providing an organised and consistent mode of collection of information on this subject, the framework may also assist OECD and non-OECD governments, conduct self-evaluations and engaging in peer reviews of their transparency measures.

As the remainder of this paper will show, the number and quality of transparency measures at national and international level in these three areas are generally on the rise.

2. Publication of relevant information

2.1. The domestic context

The availability of a clear, detailed, user-friendly and if at all possible costless description of all regulatory requirements and implementation process can be considered to be one of the most fundamental guarantors of a

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transparent and open rule-making system. Giving regulated entities full access to applicable rules is by all means not a small endeavour, however.

The increased sophistication of national economies and societal demands have given rise to an ever increasingly complex set of regulations and regulatory structures either at home or abroad. Any firm – whether of foreign or domestic origin – must not only fulfil various incorporation or registration requirements or restrictions but it must also comply with a vast array of other local regulations such as on employment and industrial relations, environment, intellectual property protection, competition policy, consumer protection, bribery, money laundering, etc. It needs to become aware of official incentives or disincentives or procurement policies that may affect its profitability. If it decides to trade or invest abroad, it must also become acquainted with the trade and investment rules that prevail in the concerned foreign countries. Beyond all this, a foreign firm may be confronted with discriminatory constraints uniquely based on his nationality.

There are also numerous sources and means by which this vast quantity of information can be disseminated. Laws and regulations may be made public in official gazettes, press releases, communiqués by government departments or regulatory agencies, government websites, etc. Depending on the media used, they can be released almost instantaneously upon adoption or with some delay. Central enquiry points may or may not be available to facilitate clarification of rules and their manner of implementation. The rules themselves may not be easily accessible to non-specialists or they may be available in plain language.

Recent work conducted by the Organisation on OECD country regulatory transparency practices suggests that *making information available on the Internet* has clearly emerged as one of the "best publication practices". Internet technology has allowed the creation of centralised online compendiums of laws and related regulations in force (*e.g.* Canada, Mexico), often equipped with search engines, offering users rapid and unabridged access to the full legal texts of laws and related regulations. Such one-stop electronic portals, which can easily be updated, often feature built-in hyperlinks to closely related websites such as sponsoring Ministries. Some countries have gone further in creating comprehensive e-gateways (such as the UK site *www.ukonline.gov.uk* or the Canada site *www.canada.gc.ca*) to enhance transparency and accessibility of government services and information.

Such increased reliance on Internet has also been accompanied by *legislative simplification* and *legal codification,* which in some countries (*e.g.* Italy and Turkey) has led to the elimination of a large number of obsolete laws. There have also been efforts to create *central registries* of government laws and

regulations. Efforts have also been deployed with varying degrees of success in favour of plain language drafting of regulations.

All things considered, however, foreign investors are often in a disadvantageous position *vis-à-vis* national investors in taking advantage of this information because of language barriers or more limited knowledge or exposure to the functioning of local institutions. Guiding foreign investors through the complex net of domestic regulatory requirements has thus come to represent an important tool of promotion policy and a central activity of foreign investment promotion agencies. Politicians and government agencies have intensified their contacts with the international business community through the organisation of special events and public appearances at various chamber of commerce or business associations and establishment of special channels of communication. Special efforts have also been made to publish information about the regulatory environment into English. In some cases, foreign investors are given direct access to the decision-making process through special advisory bodies or through official consultations procedures.

2.2. The international context

There several ways in which international agreements may enhance transparency. First and foremost, their notification and consultation frameworks themselves make regulation more transparency, among adhering countries and beyond. Moreover, many agreements stipulate concrete actions that adhering countries must take – or be prepared to take – to keep investors informed of the regulatory environment in which they will be operating.

2.2.1. The WTO

Making information relevant to foreign investors promptly available has also been made the subject of international obligations. While both the GATT[9] and the WTO Agreements are punctuated by provisions on transparency, the most comprehensive "multilateral investment policy transparency standards" of the moment are to be found in the Agreement on Trade-Related Investment Measures pertaining to goods (TRIMs)[10] and most importantly in the General Agreement on Trade in Services of the WTO (GATS) as a result of the investment dimension of "mode 3 covering the supply of a service through commercial presence". The Agreement on Trade-Related aspects of Intellectual Property Rights (TRIPs) contains transparency provisions for the enforcement of intellectual property rights that are also of interest to foreign investors.[11]

Returning to the GATS, its Article III requires members to "publish promptly … all relevant measures of general application which pertain to or affect the operation" of the Agreement. International agreements pertaining

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to or affecting trade in services to which a member is a signatory shall also be published.

This obligation is somewhat broader than other GATS obligations. It applies in all except emergency situations, and regardless of whether members made specific commitments under Article XVI (market access), Article XVII (national treatment) or Article XVIII (additional commitments). It applies to measures taken by central, regional or local government and authorities and non-governmental regulatory bodies affecting more than one service supplier.[12]

Two other transparency pillars are provided by Article III in addition to the basic "publication" obligation. members must also respond promptly to requests by other members for specific information and establish one or more enquiry points.[13] They must also promptly notify the Council for Trade in Services of any new or any changes to existing laws, regulations or administrative guidelines which significantly affect a service covered by a specific commitment.[14]

While the term "transparency" as such is not used elsewhere in the GATS, other provisions are moving in the direction of enhanced transparency. This is notably the case with Article VI on Domestic Regulation which targets the objective of creating more transparent regulatory decision-making, implementation and enforcement.[15] Sector-specific transparency obligations can be found in the WTO telecommunications Reference Paper[16] and the WTO Disciplines on Accountancy. Also, despite the recognised shortcomings of the "bottom-up approach", a certain degree of "revealed regulatory transparency" emanates from the national schedules of specific commitments, particularly those pertaining to mode 3. The Trade Policy Review Mechanism is the other major WTO instrument for ensuring transparency.[17]

A number of observers are of the opinion,[18] however, that compliance with the publication obligation of the GATS largely relies on member countries' own appreciation of the requirements and that no comprehensive review of member country practices has been undertaken. The current enquiry system has also apparently not been often consulted. Discussions are under way within the WTO, notably in the Council for Trade in Services and the Working Group and Trade and Investment, on how to improve transparency in domestic regulation. Transparency is also a central concern of ongoing WTO work on government procurement.[19]

2.2.2. BITs/RAs

While bilateral investment treaties (BITs) have traditionally not addressed the subject of transparency, recent regional trade agreements (RAs) and a new generation of bilateral trade/economic agreements devote special

provisions or even chapters to this subject, some of which are directed at foreign investment. NAFTA, the Agreement between Singapore and Japan for a New-Age Economic Partnership, the Australia-Singapore Free Trade Agreement, the Association Agreement between the European Community and Chile,,the United States-Singapore Free Trade Agreement and the United States-Chile Free Trade Agreement provide a good illustration of this trend.

In all these six agreements, transparency starts with a *publication* obligation of an horizontal nature, meaning that it applies to all laws, regulations, procedures and administrative rulings of general application respecting any matter covered by the Agreement. The Singapore/Japan Agreement extends this requirement to "judicial decisions of general application" and international agreements. NAFTA, the EC-Chile, the US FTAs with Singapore[20] and Chile foresee furthermore the establishment of *contact points* to "facilitate communications between the parties". These contact points must be able, upon request, to identify the office or official responsible for the matter and assist as necessary in facilitating communication with the requested party. Parties to these agreements are obliged to *notify* any other interested party of any measure (actual or proposed) that the party considers might materially affect the operation of the agreement or otherwise substantially affect that other party's interests under the agreement.[21] As in the WTO, the new agreements contain more elaborated sector-specific transparency requirements, notably on financial services and telecommunication services. Finally, a great deal of transparency results from the *top down approach* adopted for the scheduling of individual liberalisation commitments. Additional transparency is generated by the scheduling of individual country commitments, particularly as regards the *top down approach* applied across the board by NAFTA, Singapore-Australia FTA, and with respect to services sectors under the US FTA with Singapore and Chile (with the exclusion of non-service sectors, the scheduling of which relies on a *bottom up approach*).

Knowledge about the respective regulatory frameworks of the parties is also broadly enhanced by articles of co-operation in specific fields, which include exchange of information undertaken between the parties. The EU/Chile agreement encourages the parties to "establish mechanisms for providing information, identifying and disseminating investment rules and opportunities". It also contains a rather novel provision "promoting regular meetings" with representatives of civil societies[22] "in order to keep them informed on the implementation of the Agreement and gather their suggestions for its improvement".

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2.2.3. APEC

At Los Cabos, Mexico, on 27 October 2002, APEC[23] Leaders adopted a *Statement to Implement APEC Transparency Standards* which conveys the belief that transparency is an important element in promoting economic growth and financial stability at domestic and international levels and that it is conducive to fairer and more effective governance as well as improving public confidence in government. It also confirms that transparency is a basic principle underlying APEC trade and investment liberalisation and facilitation efforts. It encourages each APEC economy to make increased use of Internet to ensure that laws and regulations, and progressively procedures and administrative rulings, of general application are promptly published or otherwise made available and that interested persons and other economies become acquainted with them. Each economy is invited to have or designate an official journal or journals for this purpose.

These activities are to be carried out in accordance with the general guidelines for implementing an Individual Action Plan (IAP)[24] which in the area of investment liberalisation and business facilitation list as a possible menu of options in the transparency area, the possibility of making available to investors timely updates of changes to investment regimes, publishing or otherwise making publicly available information on an economy's investment laws and regulations, and procurement procedures, conducting briefings on current investment policies and making available to investors all rules and information relating to investment promotion schemes.

2.2.4. OECD instruments[25]

While the OECD instruments do not contain a general article on transparency, this objective is promoted through a notification, consultation and examination framework. Non-conforming measures to their most fundamental obligations – non-discrimination – must be notified to the Organisation within 60 days of their adoption or amendment. Detailed reports on country positions under the instruments are submitted for peer reviews and publication.

The Declaration on International Investment and Multinational Enterprises[26] provides additional clues about the international investment policy areas which deserve particular attention, including from the point of view of transparency. The National Treatment instrument, in particular, identifies five broad categories of country exceptions to national treatment that need to be singled out to the Organisation, namely investment by established foreign-controlled enterprises; official aids and subsidies; tax obligations; government purchasing and access to local finance. Measures based on public order and essential national security considerations,

monopolies and concessions and corporate organisation restrictions must also be reported for the sake of transparency. Such scrutiny also applies to the new adherents to the Declaration in the form of comprehensive reviews of their regulatory framework for FDI and the general business environment. The International Investment Incentives and Disincentives instrument, on the other hand, recognizes that adhering countries to the Declaration may be affected by this type of measure and stresses the need to strengthen international co-operation in this area. It encourages these countries to make such measures as transparent as possible so that their scale and purpose can be easily determined. The instrument also provides for consultations and review procedures to make co-operation between adhering countries more effective, including through participation in studies on policy trends in this field.

3. Prior notification and consultation

3.1. The domestic context

Work carried out under the OECD programme on Regulatory Reform suggests that prior notification and consultation of regulatory proposals to the public could enhance both the legitimacy and the effectiveness of regulatory measures. Recommended practices include the following: The policy objective of proposed changes should clearly be stated. The consultation procedures should be timely, transparent, open and accessible. Domestic and foreign parties should be treated in a non-discriminatory and impartial manner. Concerned parties should benefit or participate wherever possible in the preparation of regulatory impact analyses (RIAs). Regulatory authorities should be accountable for their decisions, in particular as to whether and when to engage in prior consultations, to disclose the comments received and react to or publish the reasons for taking them into account or not. Greater use could be made of independent expert advice. Regulatory authorities should also be aware of the danger of becoming captive to special interests or avoid consultation fatigue.[27]

While these recommendations have been made in the context of the public governance agenda, the OECD Working Party of the Trade Committee has engaged in a discussion of the potential benefits of prior consultation in the field of services.[28] It was felt that prior consultation in "trade-related" and "investment-related" domestic regulatory processes can provide firms with more predictable conditions in foreign markets. It can help reveal hidden discrimination that can potentially arise from subordinate measures which deviate from the founding or enabling legislation. By allowing for feedback from interested parties before implementation, prior consultation may lead regulatory authorities to reflect carefully before modifying existing legislation,

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encourage them to consider alternatives in line with best international practices and assist in the assessment of the regulatory impact. Finally, a greater comprehension of a proposed change can build support for compliance and more effective implementation once the new measures in question come into force.

Various stakeholders are known to support prior consultations as a means of enhancing transparency of trade and investment regulation. BIAC, in particular, has made a number of recommendations in this respect. It has indicated that governments should take steps to provide notice to the public at an early stage of proposals to introduce new rules or to change existing rules; that they should provide sufficient time to submit comments in a pre-determined manner and prior to decisions being taken; that they should give to the public an explanation of the reason(s) why the rules are being changed/introduced and the goals and objectives intended to be met; that they should ensure that the analysis of costs and benefits of regulation is clear and defensible; and that they should provide a reasonable period of time to allow affected persons prepare for the implementation. BIAC has also recommended that an independent agency be charged with oversight responsibility across the regulatory spectrum.

Public consultation and the use of prior notice and comment procedures have been a longstanding practice in some OECD countries (such as the United States, United Kingdom, the Netherlands and Canada). A majority of OECD countries apply systematic public consultations procedures to the development of primary legislation, a practice which is also increasingly extended to subordinate regulations. Consultation is normally applied to three main stages of regulatory development, namely prior to formulating detailed proposals as well as prior to and after formulating detailed proposals. Use of the Internet to solicit and gather public support has enhanced the potential reach of public consultations in real time, and has the added advantage of universal availability to all (online) stakeholders, national and non-national alike, regardless of geographic location. This is a process in constant evolution open to new concepts and tools such as that of "regulatory negotiation", "regulations government" and "peer reviews".[29]

3.2. The international context

The subject of prior consultation and notification has also gained in importance in recent international discussions or negotiations. In the WTO, the most advanced WTO disciplines are found in the GATT Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) and the GATT Agreement on Technical Barriers to Trade (TBT) which require an opportunity for advance comment on proposed regulations to be provided to other

members, notably where an international standard does not exist or where a domestic standard departs from the international standard.[30]

For the time being, the transparency article of the GATS (Article III) simply encourages WTO members to make available for advance comments the texts of new laws, regulations and administrative guidelines or amendments to existing ones prior to their publication. The GATS Disciplines for the Accountancy Sector goes a bit further by providing that domestic regulatory authorities endeavour to conduct prior consultation as a domestic procedure.[31] Preliminary consideration is also being given in the WTO Working Party on Domestic Regulation of the possibility of extending the GATS Disciplines to cover other services, in particular other professional services.[32]

Participants in the WTO preparatory discussions on a multilateral framework on investment (MFI) have been exploring the possibility of including obligations/provisions on "prior notification" and "right to comment"[33] drawing on other existing WTO disciplines. A recent communication by the European Communities and its member states to the WTO Working Group on Trade and Investment argues that notifying and consulting the WTO on proposed laws that substantively affect foreign investors may help ensure that any potential problems are discovered before enactment.[34] They have suggested that WTO members could endeavour to publish and notify proposed measures on FDI in advance in order to allow interested parties to become acquainted with them. Some WTO delegations have argued that this would be a too ambitious and administratively burdensome provision for a majority of WTO members.

The issue of prior consultation has recently attracted increased attention in the bilateral or regional economic co-operation context.. NAFTA (article 1802.2) provides a "reasonable opportunity" to "interested" parties to comment on new measures covered by the Agreement.[35] In the area of financial services (Article 1411), the agreement goes further by providing that, "to the extent practicable" all interested parties be "provided in advance" with any measure of general application proposed for adoption in order to allow "an opportunity" for such persons "to comment" on the proposed measure. The Los Cabos Declaration encourages APEC economies "when possible" to publish in advance or give advance notice of proposed new measures and provide an opportunity to comment on such proposed measures. The EU/Chile Agreement recognises the need for "timely consultation" with economic operators on substantial matters concerning legislative proposals and general procedures related to customs and the need to establish "appropriate consultation mechanisms". The FTAs recently concluded between the United States and Singapore and the United States and Chile contain state-of-the art consultation procedures before the issuance of regulations and advance notice and comment periods for proposed rules.[36] The article on Transparency

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in the Development and Application of Regulations of the US-Chile Agreement contains, in particular, provisions not found in NAFTA.

4. Procedural transparency

4.1. The domestic context

Although outright controls on FDI have receded significantly in almost every country since the mid-80s, less visible and nonetheless unnecessarily cumbersome regulatory or administrative requirements, notably in the form of registration, licensing and permits, can effectively frustrate investment. These formalities have risen significantly in recent years and are imposing large costs on business, both in terms of time and money.[37] Procedural transparency can help reduce administrative discretion, red tape and corruption. It is in any case essential for due process in the application of discriminatory screening or special authorisation procedures.

This is also one area where OECD countries have made decisive moves to reduce scope for unnecessary restrictiveness while at the same time encouraging greater efficiency within government. As noted before, their efforts have led to amalgamations or special registries of related licences and referral authority arrangements and the creation of "one-stop" service shops. Internet technology has also helped enhance search functions of regulatory requirements, thus facilitating compliance. National Investment Promotion Agencies have also been put to contribution as the first point of entry, or employed in an advisory capacity. Greater emphasis has been given to improved dialogue between government and business communities. Canada's example is a particularly eloquent one among several others. This country has introduced accelerated business procedures, notably through the use of "one-stop" online facilities, allowing businesses to meet a series of regulatory requirements in one integrated process instead of securing necessary authorisations from different regulatory authorities and improve access to business-related information (including through a cross-country network of Canada Business Service Centres).

Process re-engineering has been another tool for achieving greater procedural transparency. This method is based on review of the information transactions required by government formalities with a view to optimising them, including reducing their number and reducing the burden of each through redesign, elimination of steps and application of new technology, as appropriate. The most common tool in this regard is licence and permit simplification and reduction programmes. There has also been a distinctive trend away from *ex ante* controls to *ex post checking* or *silent is consent* clauses. Streamlining of border procedures has been the third major area of attention. This is also a major concern for foreign investors which rely on imported

inputs to carry their operations abroad. Certain OECD countries have become leaders in adopting fully automated clearing systems. Concepts such as self-assessment, advance information and pre-arrival documentation, and risk assessment are being increasingly deployed in support of faster movement of low risk goods, allowing a greater concentration of resources on goods with higher or unknown risk. OECD work points to major successes to date (such as in Mexico). Existing and aspiring EU member states have also greatly benefited from harmonisation and simplification under the EU Customs Code. However, the non-interoperability or geographic exclusivity of certain computer systems, lack of "single window" integrated approaches to customs clearance, lack of interface with license delivery or other permit networks and lack of transparency remain important challenges on the road of trade facilitation in several countries. Lack of comprehensive rules to guide the development of transparent and predictable custom rules is also viewed as a major shortcoming for trade and investment

4.2. The international context

Procedural transparency is a long-standing international concept.[38] GATT Article X on (the publication and administration) of trade barrier measures obliges members to administer rules and regulations of general applications in a "uniform, impartial and reasonable manner". GATS Article VI (domestic regulation) goes further in providing that when authorisation is required the competent authorities shall "… within a reasonable period of time inform the applicant of the decision concerning its application". Procedural transparency also implies a range of procedural "review rights" including the "right to file a complaint", the "right to appeal" and the "existence of judicial arbitral or administrative tribunals or procedures for prompt and impartial review and remedy of administrative decisions". The Council for Trade in Services is also working on ways to ensure that formalities do not constitute unnecessary barriers to trade.[39]

The same basic rights are spelled out in two NAFTA articles found in chapter eighteen, which is devoted to "publication, notification and administration of laws". In article 1804, "persons that are directly affected by an administrative proceeding resulting from the application of measures of general application affecting matters covered by the agreement must be provided, whenever possible, with 'reasonable notice… when a proceeding is initiated, including a description of the nature of the proceeding, a statement of the legal authority under which the proceeding is initiated and a general description of any issues in controversy'. They must also be 'afforded a reasonable opportunity to present facts and arguments' in support of their position 'prior to any final administrative action, when time, the nature of the proceedings and the public interest permit'. In article 1805, the parties are

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required to establish impartial and independent review and appeal procedures. Parties to proceedings also have the right to 'a reasonable opportunity to support or defend their respective positions', a right of access to a decision based on the evidence and submissions of record, or where required by domestic law, the record compiled by the administrative authority". Of course, relevant decisions must also be implemented (Articles 1803 and 1804).

Under Article 1411 of the Financial Services chapter, financial regulatory authorities are required to make available to interested persons their requirements for completing application relating to the provision of financial services (this provision applies to cross-border operations). On the request of an applicant, the regulatory authority shall inform the applicant of the status of its application. The administrative decision must be taken within 120 days and be promptly notified to the applicant. Under NAFTA telecommunications chapter (Chapter 13), any licensing, permits, registration of notification authorisation shall be "processed expeditiously".

Procedural transparency and due process is also becoming an important feature of the new generation of bilateral trade agreements such as the recent Singapore's FTAs with EFTA, Japan, Australia, the United States, and Chile's FTAs with the European Community and the United States. The provisions largely build upon the WTO provisions but they also entail more detailed obligations for customs and related matters, and financial and telecommunication services.[40] The Los Cabos Statement to Implement APEC Transparency Standards devotes a large section to transparency and due process in regard to administrative proceedings pertaining to investment, services, customs procedure, intellectual property rights and government procurement.

Finally the US/Singapore FTA and the US/Chile FTA present as "ground-breaking provisions" the fact that investors rights under the agreements are backed by open and transparent procedures for settling investment disputes. These agreements specifically stated that "submissions to dispute panels and panel hearings will be open to the public, and interested parties will have the opportunity to submit their views".[41] This is consistent with advocacy by some WTO members for greater transparency with respect to WTO dispute settlement through the possible inclusion of a mechanism permitting non-government stakeholders to present their written views on disputes and the WTO allowing the public to observe WTO and panel and appellate proceedings.

5. Conclusions

The general "*tour d'horizon*" presented in this paper of some of the most recent trends of FDI-enhancing transparency rules and practices attests to the

growing attention given by OECD governments to this issue. FDI has clearly benefited from OECD regulatory reforms and from the special efforts which have been made to render domestic laws and regulations more accessible to investors and to consult them more effectively on the elaboration of new ones. FDI has also benefited from the increased willingness of OECD governments to undertake transparency obligations at multilateral, regional and bilateral levels.

Obviously not the same transparency tools are directly applicable to every country. Capacity-building and cultural considerations play an important role on how information is disseminated and exchanged. Transparency also remains a moving target. New technologies, such as Internet, and more efficient government can push the frontiers of good transparency practices and set the direction for further reforms. More can still be done to secure firmer and broader policy commitments on transparency.

Notes

1. See, in particular, the recent publication by the World Bank Group *Global Economic Prospects and the Developing Countries,* 2003, page 124.
2. Paragraph 22 of the Doha Declaration states that "In the period until the Fifth Session, further work in the Working Group on the Relationship Between Trade and Investment will focus on the clarification of: scope and definition; *transparency*; non-discrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards".
3. See paragraph 21 of the United Nations Report of the International Conference on Financing for Development held in Monterrey, Mexico in September 2002 (*http://ods-dds-ny.un.org/doc/UNDOC/GEN/N02/392/67/PDF/N0239267.pdf?OpenElement*
4. See *Regulatory Policies in OECD countries: From Interventionism to Regulatory Governance*, OECD, 2002.
5. See *Public Sector Transparency and Accountability: Making It Happen,* OECD, 2002.
6. See *OECD E-Government Studies: The E-Government Imperative*, OECD, 2003.
7. See *Integrating Market Openness into the Regulatory Process: Emerging Patterns in OECD countries* [TD/TC/WP(2002)25/FINAL].
8. The Declaration on International Investment and Multinational Enterprises is a political agreement providing a balanced framework for co-operation on a wide range of issues designed to improve the domestic regulatory framework for investment and encourage the positive economic contribution by multinational enterprises. All *30 OECD member countries*, and eight non-member countries (Argentina, Brazil, Chile, the three Baltic States – Estonia, Latvia and Lithuania –, Israel and Slovenia have subscribed to the Declaration. For further information see *www.oecd.org/EN/document/0,,EN-document-9-nodirectorate-no-6-16767-9,00.html#title1*
9. The importance of transparency to an effective trading system is at the origin of Article X of the GATT on "Publication and Administration of Trade Regulations"

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which includes special provisions for the publication of laws and other measures affecting trade in goods, as well as their administration.

10. TRIMS Article 6 reaffirms commitments with respect to Article X of the GATT, as well as notification procedures, including the Ministerial Decision on Notification Procedures adopted on 15 April 1994 (WTO document symbol LT/UR/D–1/5).

11. Given the importance of the protection of intellectual property rights for international investors, it is indeed worth mentioning the inclusion of Article 63 of the TRIPs in the Dispute Prevention and Settlement chapter of the Agreement. Article 63 specifically provides that relevant laws and regulations, and final judicial decisions and administrative rulings of general application that affect the operation of the Agreement shall be published in such a manner as to enable governments and rights holders to become acquainted with them. Any agreements concerning the subject matter of the TRIPs must also published. In addition, WTO members must be prepared to supply, in response to a written request from another member, information pertaining to these various rules and regulations.

12. In fulfilling its obligations and commitments under this Agreement, each member shall take such reasonable measures as may be available to it to ensure their observance by regional and local authorities to ensure their observance by regional and local government and authorities and non-governmental bodies within its territory. Article 13(a).

13. The list of enquiry points is available at *www.wto.org*. Some 86 enquiry points have been established and notified to the WTO as of June 2002.

14. Pursuant to Article III.3 of the GATS, some 210 notifications have been made as of June 2002. Most of the notifications provide either the reference of the legislation or the national enquiry points. This raises the question of the utility of the contact points.

15. See also Soonhwa Yi and Sherry Stephenson, *Transparency in Regulation of Services*, July 2002.

16. The GATS Telecommunication Annex contains specific provisions on the publication of information about conditions for access to, and use of public network and services.

17. The objectives of the Trade Policy Reviews are "to increase the transparency and understanding of countries' trade policies and practices, through regular monitoring, to improve the quality of public and intergovernmental debate on the issues and to enable a multilateral assessment of the effects of policies on the world trading system". See *www.wto.org Trading into the future – agreements – trade policy reviews*.

18. See in particular, Soonhwa Yi and Sherry Stephenson, *Transparency in Regulation of Services*, Meeting of APEC Group on Services, Merida, Mexico, 16-18 May 2002.

19. At the Ministerial Meeting in Doha, WTO members also agreed "that negotiations will take place (in this area), after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations… Negotiations shall be limited to the transparency aspects and therefore will not restrict the scope for countries to give preferences to domestic supplies and suppliers".

20. The US-Singapore FTA Agreement was signed by President Bush and Singapore Prime Minister Goh on 6 May 2003. See *www.whitehouse.gov/news/releases/2003/05/20030506-11.html*
21. This is in contrast to the WTO obligation which only applies to new or amended legislation pertaining to a scheduled service.
22. Including the academic community, social and economic partners and non-governmental organisations.
23. The Asia-Pacific Economic Forum, created in 1989 is the primary international organisation for promoting open trade and international co-operation among the 21 Pacific Rim countries including 7 OECD countries, Russia, China, Hong Kong, Chinese Taipei, Singapore and Chile.
24. The Individual Action Plan (IAP), now available in an electronic form (*www.apec-iap.org/*) is a report updated annually by each APEC member Economy which records its actions that help realise the APEC goal, set down in *Bogor*, Indonesia, of free and open trade and investment in the APEC region by 2010 for industrialised economies and 2020 for developing economies. In line with the concept of concerted unilateral liberalisation, APEC member economics undertake these actions on a voluntary and non-binding basis.
25. While no agreement was reached on any MAI provision at the time the negotiations ended in May 1995, the draft consolidated text contained a transparency article which provided for a general commitment to broadly publish relevant information of general application which could affect the operation of the Agreement, promptly respond to specific enquiries and provide routine information (such statistical information) while protecting confidential or privy business information. While public dissemination of investment-related information was considered essential, the consolidated text language reflected a balance between this objective and the administrative burden of implementing it. Negotiators did not have time to complete their discussion on a notification of obligations. See www.oecd.org/daf/mai.
26. See *www.oecd.org/EN/document/0,,EN-document-9-nodirectorate-no-6-16767-9,00.html#title1*
27. See Annex IV, *OECD Regulatory Policies in OECD Countries*, 2002.
28. See in particular, *Trade in Services, Transparency in Domestic Regulation: Prior Consultation,* TD/TC/WP(2000)31/Final.
29. Regulatory negotiation is a relatively new tool in the United States involving negotiations with specific interest groups. Regulations.gov launched on 23 January 2003 is a new consolidated online rule-making Web site for the entire federal government intended to provide one-stop point of entry for citizens to comment on open rules from all agencies via e-mail. In its 2002 Report to Congress on the Costs and Benefits of Regulations and Unfunded Mandates on State, Local and Tribal Entities, the Office and Management and Budget reports a growing interest for external peer review of Regulatory Impact Analyses.
30. If a member has reason to believe that a measure introduced or maintained by another member is trade restricting, an explanation of the reason for such a measure may be requested "and shall be provided by the member maintaining the measure". The TBT Agreement extends the reach of its transparency provisions to cover governmental and non-governmental standard-setting bodies through its Code of Good Practice for the Preparation, Adoption and Application of Standards. Compliance with the Code is obligatory for central government standardising

bodies, and encouraged for other standardising bodies. The Code requires advance publication and a 60-day comment period during which all "interested parties within the territory of a member of the WTO" may submit comments, and request a reply from the body.

31. According to the Disciplines (paragraph 6), when introducing measures significantly affecting trade in accountancy services, members shall endeavour to provide opportunity for comment, and give consideration to such comments, before adoption. members shall inform another member, upon request, of the rationale behind domestic regulatory measures in the accountancy sector, in relation to legitimate objectives. Preliminary consideration is under way in the WTO Working Party on Domestic Regulation of the possibility of extending the Disciplines to cover other services, in particular other professional services.

32. See the last Report of the Working Party on Domestic Regulation to the Council for Trade in Services of 6 December 2002 (S/WPDR)4.

33. See WT/WFTI/6, Report (2002) of the Working Group on the Relationship between Trade and Investment to General Council.

34. See WT/WGTI/W/110 Communication from the European Community and its member States, March 2002.

35. Article 1411 of the financial services chapter of NAFTA uses instead the following more elaborate language: "… Each Party shall, to the extent practicable, provide in advance to all interested persons any measure of general application that the Party proposes to adopt in order to allow an opportunity for such persons to comment on the measure. Such measures shall be provided: *a)* by means of official publication; *b)* in other written form; or *c)* in such other forms as permit an interested person to make informed comments on the proposed measure."

36. See Trade Facts, *www.ustr.gov*.

37. For a comprehensive description of these arguments, see *Regulatory Policies in OECD countries, from Intervention to Regulatory Governance*, 2002, Chapter 4. This section also draws on the findings of the Trade Directorate's study TD/TC/WP(2002)25/Final mentioned before. The World Bank Foreign Investment Advisory Service (FIAS) has also done considerable work in this area in fulfilment of its mandate to improve developing countries' investment environments in order to attract FDI (*www.fias/net*).

38. Detailed WTO provisions on due process can be found in several WTO agreements, notably the GATS, the TRIPS Agreement, the agreements on Subsidies and Countervailing Measures, Anti-Dumping Measures, Customs Valuation, Import Licensing Procedures and Pre-Shipment Inspection. For recent description of these provisions, see the Note by the WTO Secretariat, WT/WGTI/W/109.

39. For example, the Council for Trade in Services has been requested to develop requirements and disciplines with a view to ensuring that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services.

40. There is also an interesting provision in the Singapore/FTA agreement which goes further than GATS Article VI: Article 64(2) states that "In sectors where a Party has undertaken specific commitments subject to any terms, limitations, conditions or qualifications set out therein, the Party shall not apply licensing and qualification requirements and technical standards that nullify or impair such specific commitments in a manner which: *a)* does not comply with the following criteria: *i)* based on objective transparent criteria, such as competence and the ability to

supply the service; *ii)* not more burdensome than necessary to ensure the quality of the service; or *iii)* in the case of licensing procedures, not in themselves a restriction on the supply of the service and (b) could not reasonably have been expected of that Party at the time the specific commitments in those sectors were made."

41. USTR also seeks public comment, through a Federal Register notice, on every dispute settlement proceeding where the United States is a party. It also makes its written submissions to panels and the WTO Appellate Body available to the public as soon as they are submitted.

*Foreign Direct Investment in Professional Services: Making National Regulation More Transparent**

Services industries play an important role both in developed and developing markets, accounting for a large and growing share of economic output and employment. Although developed economies continue to account for the lion's share of the world market for services, developing countries' participation in this market has increased in recent years, due in part to the new cross-border delivery options made possible by innovations in information and communications technology. Data also indicate that developing countries host and increasing share of FDI stock in the services industries, even though the OECD area accounts for the majority of implantations of foreign firms in the services sector.

Professional services are among the most rapidly growing economic activities in the services area. Internationalisation is a marked trend, driven *inter alia* by increased demand resulting from expanding foreign direct investment and establishment in other sectors of the economy. In this context, firms providing accountancy, legal or other professional services to major domestic clients find it increasingly important to follow these clients in their ventures abroad by establishing a commercial presence in foreign markets.

1. Trends in cross-border investment

Figure 4 endeavours to reflect this growth of international investment in professional services through charting the number of cross-border mergers and acquisitions[1] (M&As) which took place in these services sectors within the OECD area 1995–2002. A rapid growth in the number of transactions during most of the past decade is clearly demonstrated. Moreover, a change in composition has taken place. In the mid-1990s, engineering services

* This article was prepared by Eva Thiel, Principal Administrator, Capital Movements, International Investment and Services Division, OECD, on the basis of a report by the OECD Committee on Capital Movements and Invisible Transactions presented to the OECD Council in March 2003.

Figure 4. **Cross-border M&As in professional services, OECD total**

Number of transactions

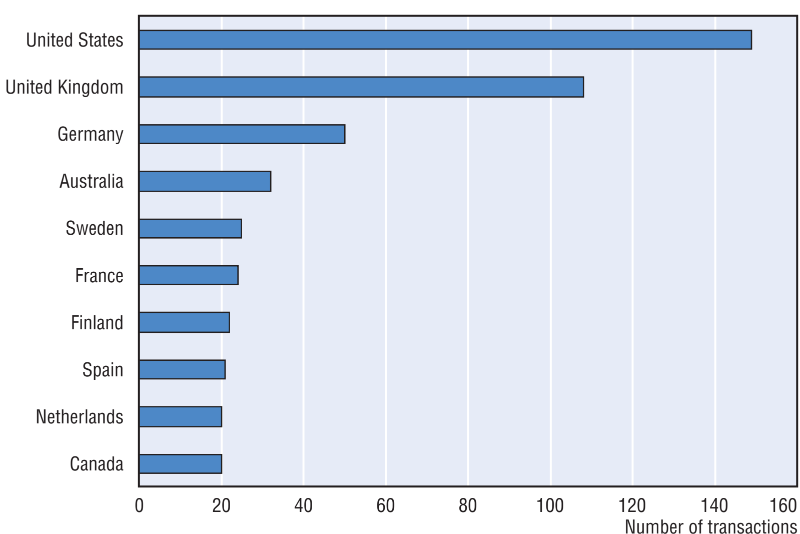
Year	1995	1996	1997	1998	1999	2000	2001	2002

Source: Dealogic.

dominated the cross-border investment in professional services by a wide margin, but during the last five years the importance of cross-border M&As in legal and accounting services has steadily increased. However, because of the normally higher capitalisation of engineering firms than those in other categories of professional services, engineering services still dominate in terms of value of bids.

As to the major recipient countries, 10 countries recorded at least 20 cross-border transactions over the period under review (Figure 5). However, by far the largest recipients (and to a lesser extent also originating countries) were the United States and United Kingdom. It is not possible to conclude in a straight-forward manner that those two necessarily operate the most liberal regulatory framework for inward FDI in professional services. Many other factors may account for the position of a recipient country in a prominent position in the ranking, including the presence of major international financial centres. FDI in legal advisory and accountancy services is naturally stimulated by the wish of foreign firms to gain access to intangible assets and externalities existing *e.g.* in the financial centres in London and New York.

Figure 5. **Cross-border M&As in professional services: main 10 recipient countries, 1995-2002**



Source: Dealogic.

2. Restrictions on cross-border investment

Both international trade and investment in professional services may be hampered by a complex mixture of restrictions and regulations which are characteristic for this highly regulated sector. Foreign investment may be adversely affected by, for instance, nationality, residence or local licensing requirements or prohibitions on incorporation as well as on partnerships between foreign and locally qualified professionals. Not only do existing restrictions need to be fully transparent. The issue is also to what extent they are necessary and whether they could be replaced by measures which do not constrain foreign investment to the same degree.

OECD has been for almost a decade in the forefront of new efforts to combine more freedom for international supply of professional services with safeguarding quality of service and protection of consumers. Three OECD workshops on professional services were organised in the period 1994-1997. These brought together representatives from the business sector as well as from government, each resulting in the adoption of a concrete set of common understandings, and each building on the achievements of the previous event. The work of the OECD Trade Committee in this field developed since these workshops took place is also relevant.

The extensive analytical work carried out was intended not only as a benefit to OECD members but also as an input into the WTO work on

liberalisation of professional services and to clearly recall the policy rationales for pursuing open professional services markets through liberalisation of trade and investment. Since 1995, the entry into force of the WTO General Agreement on Trade in Services (GATS) and the launch of a specific GATS mandate on professional services have further underpinned the general trend towards globalisation of the execution and delivery of professional services, for which both by internationalisation of higher education and the advent of new communications technologies are important factors.

The OECD also needs to ensure that its own legal instruments, the Codes of Liberalisation of Capital Movements and of Invisible Operations remain supportive of this trend and raise the transparency of member countries' practices regarding professional services[2]. For OECD members, these instruments provide more comprehensive liberalisation and transparency obligations than GATS provisions, through their reliance on a" "top-down" framework where all services sectors not specifically reported as containing restrictions must be considered free. Under the Code of Liberalisation of Capital Movements, member countries are obliged to grant non-discriminatory access to foreign investors wishing to provide professional services, unless they have lodged a reservation under the Code, stating the nature and extent of the restriction.

As emerged from the workshop discussions, it may not always be easy to decide whether host country rules on professional services discriminate against foreign enterprises, or whether they address a legitimate regulatory concern. Consequently, situations of doubts whether existing restrictions require a reservation or not have occasionally arisen.

Since the early 1990s, OECD has worked on developing common understandings as to what kind of regulations on professional services constitute an unjustified discrimination and therefore require a reservation under the Code. The material presented in this article results from these efforts to align and harmonise reservations to the Code with existing restrictions, with special emphasis on achieving maximum transparency through as precise wording as possible of the reservations, which are posted and regularly updated on the OECD official website.

In addition, ways and means to advance regulatory reform in the professional services sector are discussed in the article, including alternative, less burdensome approaches to restrictions on investment which members were encouraged to consider.

The restrictions to inward direct investment and the right of establishment examined concern accounting, legal, engineering and architectural services.[3] The review is based on an inventory of measures,

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which was prepared for the workshops, as well as on supplementary information provided by member countries.

The Code does not contain a precise definition of accounting, legal, engineering and architectural services. It has therefore been left to individual member countries to take account of their national laws and regulations which define the scope of activities that fall under a specific category of service, while aiming at the same time to harmonise the text of their reservations as much as possible with those of other member countries.

Section III of the present article examines the scope of member countries' obligations regarding professional services under the so-called Item I/A ("Direct Investment and Establishment") of the Capital Movements Code and provides comments on member countries' current measures and position under the Code. Section IV considers motivations underlying restrictions and suggests alternative, less restrictive approaches. A list of OECD members' current restrictions (the so-called" "reservations") under the Capital Movements Code is provided in the Annex.

3. The disciplines of the Capital Movements Code with respect to professional services

Under the Capital Movements Code, member countries have legally binding obligations to notify OECD of any existing restrictions affecting direct investment in the professional services sector, to apply any measures without discrimination among OECD countries[4] and to abstain from applying restrictions not covered by a reservation to Item I/A." "Liberalisation" in the Codes means the abolition of measures (laws, decrees, regulations, policies and practices) taken by the authorities which may restrict the conclusion or execution of transactions and transfers with respect to the operations specified in the Codes. The liberalisation obligations apply only to operations between the residents of OECD member countries adhering to the Codes.

3.1. Nationality requirements

Nationality requirements discriminate against non-resident investors. They constitute restrictions calling for reservations under Item I/A to the extent that they apply to ownership of a professional services enterprise. Since Item I/A only applies where professionals are able to establish a firm with legal personality (or constituting an enterprise, or a subsidiary or branch of an enterprise having legal personality abroad), nationality requirements applying to the establishment of individuals as self-employed persons are not covered.[5] For the purposes of this study, it has been assumed that partnerships between individual professionals would normally not constitute an enterprise. As a consequence, nationality requirements in sectors where

incorporation is not permitted would not give rise to reservations. member countries are, however, invited to provide any clarification on the legal status of partnerships under their national laws which might qualify them as" "enterprises" within the meaning of Item I/A.

Should the possibility to incorporate become available in the future in any country for professions where this is not the case at present, Item I/A would begin to apply. Any nationality or residence requirements maintained would then have to be notified and appropriately reflected in reservations under the Code.

In a majority of cases, the nationality requirement is not imposed as a direct condition of ownership, but as a condition to obtain a local licence which, in turn, is necessary to own or hold shares in a professional services firm. Since, however, the effect of such restrictions is to prevent all foreign nationals from owning or establishing a professional services firm, they should require the lodging of a reservation to Item I/A as well. This is also consistent with the treatment of nationality requirements affecting cross-border professional services. Where holding participations, including a controlling position, in a professional services firm is permitted for non-professionals or foreign-licensed professionals, a nationality requirement as a condition (whether imposed on employees or shareholders of the firm who want to practice as active professionals) for obtaining a local license would be irrelevant to Item I/A.

It is possible, however, that nationality requirements applying to directors and senior management of a professional services firm might have an inhibiting effect on the establishment of a firm by non-residents. Again, such requirements may apply directly or indirectly by requiring a local license which is reserved to nationals. The Committee has agreed that the question of whether such restrictions have a decisive effect on investment has to be examined on a case-by-case basis.

Where professional services are exclusively supplied by government bodies – so that neither foreign nor national firms can establish in that particular sector – any nationality conditions are irrelevant.

The examinations carried out during the workshops showed that a considerable number of OECD countries maintain nationality and/or local presence requirements for one or several professions which affect foreign investors.

In general, nationality and citizenship requirements are not uncommon in the accountancy and legal field, while they affect engineering and architecture only in very few member countries. Considering all professions together, eleven out of the 30 OECD members maintain nationality

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requirements, which are, with very few exceptions, imposed either as a condition for obtaining a local licence or, for use of the local title.

However, not all of these nationality conditions are relevant to investment as covered by Item I/A of the Code. As mentioned above, where the establishment of an enterprise is prohibited in one or more of the professions concerned, the nationality requirement is irrelevant to Item I/A. Where the nationality requirement pertains only to use of the local professional title, this is only considered a restriction on investment, if holding such a title is also required for ownership of incorporated professional firms. In some cases, however, a nationality requirement may be linked to the local licence, but such a licence is not always required for ownership of a firm by non-nationals.

As a result, the number of members lodging reservations to Item I/A on account of nationality or citizenship requirements maintained for certain professions was reduced to seven (Austria, Belgium, Finland, Greece, Mexico, Spain and Turkey – see Annex). In a majority of cases, only one profession – either accountants or lawyers – was concerned. Sometimes, the requirement for investors to hold a local licence reserved to nationals of the host country only applies to firms wishing to provide certain regulated services within the profession, such as auditing of public companies, or court representation.

3.2. Local presence requirements

Residence and other local presence requirements may be relevant to Item I/A to the extent that they concern shareholders of a firm, or directors and senior management. Where non-residents may not hold shares in a professional services firm, whether this is the result of a residency requirement linked to a local licence or not, this should give rise to a reservation to Item I/A as in the case of nationality requirements. Again, the requirement of a local presence matters solely if it prevents ownership of an enterprise by non-residents, irrespective of whether, at the same time, it prevents cross-border supply of professional services.

With regard to residency requirements for directors and senior management, the Committee considered that they constitute a less burdensome regulatory alternative rather than an outright restriction. Indeed, imposing such a condition might allow regulators to avoid restrictions on incorporation or foreign ownership. In addition, since such requirements often tend to apply horizontally rather than being specific to the professional services sector, it was found more appropriate for the purposes of the review not to consider them as restrictions under the Capital Movements Code.

In some instances, the residency requirement is replaced by the obligation to appoint a local representative, or, as regards locally licensed professionals, to provide a professional address. Since this will not necessarily

require the shareholder in a professional firm to become a resident of the host country, it was proposed that such conditions should not give rise to reservations.

As in the case of nationality requirements, residency requirements would not give rise to reservations where they can only affect natural persons, *i.e.* where legal persons may not establish or invest at all in the sector concerned. Should incorporation, however, become available as a form of business in the future, Item I/A would begin to apply to residency requirements for shareholders and the lodging of reservations might become necessary.

While almost all OECD member countries impose local presence requirements for one or more of the four professions, with auditing and legal services coming in first and second by a considerable margin, their relevance to Item I/A is often cancelled out by the fact that establishment of an enterprise is prohibited in the relevant sector for both domestic and foreign service providers. Thus, they imply reservations to Item I/A less frequently than they do with respect to cross-border supply of services under Item L/6 of the Invisibles Code.

As in the case of nationality requirements, residency requirements in virtually all cases tend to be attached to a local professional licence which in turn is needed for ownership. In some countries, a professional licence is subject to both nationality and local presence conditions. In this case, a local presence requirement is not relevant to foreign investors, since they are already precluded from market access by virtue of their nationality. It may, however, become relevant to Item I/A in the future once the member countries concerned decide to abolish their nationality requirements.

Once account is taken of all the considerations above – local presence requirement in the absence of a nationality requirement, licence required for ownership and incorporation permitted – only four countries maintain a local presence requirement restricting non-residents from ownership of a professional firm and requiring a reservation to Item I/A (Denmark, Finland, Norway and Sweden – see Annex). Of these, one case concerns the accountancy sector, and the three others both the accountancy and legal sectors.

As mentioned before, some countries have replaced traditional local presence requirements for professionals by less burdensome requirements, such as the registry of a professional address in France. In other countries, the license required for ownership is subject to maintaining an office in the host country, without requiring the licensee to be personally resident. Such conditions are easy to fulfil for foreign-based owners of professional firms,

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since the establishment of a firm per se implies the maintenance of an office and a professional address

3.3. Restrictions on form of business

Are restrictions on the form of business relevant to Item I/A of the Capital Movements Code? The Committee has in the past taken the position that they are when dealing with an obligation to incorporate (as opposed to permitting branching), even if applied to residents and non-residents alike. Its rationale was that such obligations required non-resident investors to engage in a second incorporation, and thus placed a heavier burden on them as compared to residents.

In the professional services sector, we are, however, dealing almost exclusively with the opposite case: Professionals are either not allowed to incorporate at all, or restricted to certain forms of incorporation. This condition is in general applied in a non-discriminatory manner to nationals and foreigners alike. It has, however, the potential to affect foreign firms' access to the market since it restricts their ability to establish subsidiaries and branches and may also prevent foreign firms from conducting business using the parent practice's name. This applies in particular where no incorporation at all is permitted.

The case for arguing that this results in discrimination between resident and non-resident investors requiring a reservation to Item I/A appears, however, less strong than with regard to the obligation to incorporate mentioned above. Its discriminatory effects on foreign firms are more uncertain and will depend on the circumstances of each case. Where restrictions on incorporation affect foreign firms' business opportunities to the point that they can be considered as *de facto* restrictions, it is possible that Article 16 of the Code could be invoked, particularly if no incorporation at all is permitted. (Article 16 provides that action may be taken" "[i]f a member considers that the measures of liberalisation taken or maintained by another member… are frustrated by internal arrangements likely to restrict the possibility of effecting transactions or transfers, and if it considers itself prejudiced by such arrangements".)

Although non-discriminatory prohibitions on incorporation do not require reservations to Item I/A, they were nevertheless recorded during the examinations, for their role in indicating in which countries and sectors investment in professional services is excluded in practice.

It was found that accountants are not allowed to incorporate in eight member countries (Australia, most provinces of Canada, Ireland, Italy, Japan, Portugal, New Zealand and some US states), with the prohibition applying, in general, to accountants carrying out statutory audit. A substantial number of

member countries likewise prohibit incorporation for the purpose of providing full legal services (nine, but not all the same as for accountants). Only three members (Canada, Italy and Portugal) exclude incorporation for architects and/or engineers.

Among those countries permitting professionals to establish an enterprise, many restrict the forms of incorporation available. The full range of business forms is available to accountants, including auditors, in five member countries only (see Annex). With regard to lawyers, four members reported that no legal restrictions exist on the form of business (on condition, in two cases, that the local title is not used). An overwhelming majority of OECD member countries permit all legal forms of business for the establishment of engineering and architect firms.

3.4. Local licensing requirements

Licensing requirements may include an obligation for owners of professional firms to hold local qualifications, even if they do not wish to practice in the host country. These requirements are nevertheless considered consistent with the disciplines of Item I/A provided that they do not discriminate against non-resident suppliers.

Where access to a local license is relatively easy for foreign professionals, for instance through recognition of their home country professional qualifications, they may suffer little or no *de facto* restriction on their ability to hold participation in a local firm. At the opposite end of the scale, licensing requirements that amount to a full retraining obligation for foreigners may *de facto* almost entirely prevent ownership of local firms by foreign professionals. Particularly in the case of foreign professionals not wishing to practice in the host country, few would consider it reasonable to retrain for years in order to be able to hold shares or participations in a locally established firm. This may unfairly reduce their business opportunities in the host country. Such restrictions, while not requiring reservations, may therefore entitle a member country to invoke the disciplines of Article 16 of the Code.

Measures by self-regulatory organisations affecting investment should be recorded as restrictions under the Code, provided these organisations are acting under delegated authority from the government. The reason is that, in this case, they can be considered as measures by the government itself. In the professional services field, it is not uncommon that professional organisations or associations, including privately controlled entities, are authorised to design regulations. Cases may arise where such entities deny equal market access conditions to foreigners or non-residents. It may also occur that governments require membership of a given local professional association as a condition of ownership of a professional services firm. Where, in such cases,

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membership may be denied by the association concerned on nationality or residence grounds, this should be regarded as a restriction under the Code.

Almost all OECD member countries require a local professional licence for shareholders in an accounting or law firm, while only a minority do so for engineering and architects' firms. In most cases these requirements are non-discriminatory and based on objective criteria. A few members permit minority shareholding by foreign professionals in an accountancy firm, while a somewhat larger number allow minority shareholding by non-professionals.

As noted above, the requirement of a local licence may have a very dissuasive effect on foreign investors. Where years of retraining are needed for the sole purpose of owning shares in a professional firm, without necessarily intending to practice, few will find it worthwhile. Whether it makes economic sense for foreign investors to acquire a licence will depend on factors such as the availability of systems for the recognition of their home country qualification, of simplified aptitude tests, short periods of complementary training etc. While OECD member countries have reported during the workshops a growing trend towards the introduction of such facilities, it would go beyond the scope of this article to review in detail existing possibilities for the recognition of foreign professionals.

3.5. Discrimination among OECD member countries

Discrimination among OECD member countries is contrary to Article 9 of the Code. Article 10 provides an exception for special customs or monetary systems. So far, only the Belgium-Luxembourg Economic Union and the European Community have been recognised as special systems under Article 10. In other instances (NAFTA, EEA) differential treatment among OECD member countries has not been determined to be consistent with the provisions of the Code and is thus not reflected in reservations to the obligations of the Code. This also applies where discrimination is based on reciprocity considerations.

Selective recognition agreements can, in principle, be relevant to Item I/A in those cases where establishment and ownership of a firm require a professional licence. However, such agreements mostly establish conditions under which discrimination is based on objective technical criteria. In these circumstances, they would be compatible with the Code's non-discrimination provisions.

Where, however, recognition agreements include nationality or residency criteria for the professional, rather than quality assessments with regard to degrees or qualifications obtained, such requirements constitute potential violations of the non-discrimination principle of Article 9 of the Code. In these cases, the host member country concerned should stand ready to afford third

OECD countries adequate opportunity to demonstrate that comparable circumstances exist for similar recognition of their licensing requirements, degrees, etc. Recognition relying on the country of acquisition of licenses, degrees, or working experiences per se would be susceptible of a similar interpretation.

Thus, as a general rule, discrimination among OECD countries should be removed from professional services regulations, with the only exceptions being those permitted under Article 10 of the Code.

Several EU member countries have reported nationality or residency requirements for one or more professions which only apply to nationals of non-EU countries, thus giving rise to reservations to Item I/A with an EU preference (Austria, Belgium, Denmark, Finland, Greece, Spain and Sweden). In some cases (Italy and Portugal) these restrictions fall outside the scope of Item I/A since incorporation in the profession concerned is prohibited in the relevant EU member.

Finally, reciprocity conditions apply in a number of OECD member countries. The Committee has not yet adopted a common stand regarding reciprocity measures under the Capital Movements Code (other than those listed in Annex E to the Code).

3.6. Measures by sub-national units of government

Measures by sub-national units of government – which are frequent in the professional services sector – are subject to the full disciplines of the Code, except for measures taken by the States in the United States (by virtue of Annex C to the Code). Canada's obligations regarding measures by her provinces are defined by a General Remark in Annex B. Australia maintains a full reservation to Item I/A regarding measures by its states and territories.

All three members have reported restrictions at sub-federal level. In Australia, these concern only restrictions in the legal services sector on forms of business and licensing requirements. In Canada, most provincial authorities prohibit incorporation for accountants and lawyers or require residency for licensed shareholders. In the United States, some states do not allow for ownership of accounting, architectural engineering or law firms by unlicensed individuals. Foreign nationals may be admitted to practice as foreign legal consultants in 24 jurisdictions, in accordance with special provisions. Additionally, in Switzerland, nationality requirements are imposed by some cantons on lawyers.

4. Motivations for restrictions and alternative approaches

The main concern behind restrictions regarding the ownership of professional services firms is to protect consumers and the public interest

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more generally. In this context, *nationality requirements* appear to be on the retreat, with a number of countries no longer considering that they could be reliable indicators for concerns about local knowledge.

Proponents of the *prohibition of incorporation* are reported to be concerned that establishment as a joint stock company, a limited liability company, etc., may reduce the accountability of professional service suppliers *vis-à-vis* their clients by limiting personal liability in case of professional fault or malpractice. The need for excluding non-professionals from ownership and control of a firm providing professional services may be motivated by fears that this could threaten the independence and integrity of the professional services supplied. The requirement for investors to hold a *local licence* is said to ensure that the firm respects rules and other conditions in the host market, and that services are rendered with the necessary competence expected by the public in the host country. *Residency requirements* for shareholders in a professional services firm probably affect the latter only incidentally as an element of local licensing requirements; considerations such as the need to enforce ethical rules and codes of conduct have been expressed with regard to professional practice, rather than with regard to ownership not involving the personal exercise of the profession.

Participants in the Third OECD Workshop on Professional Services discussed ways and means to advance regulatory reform in the professional services sector. This included a search for alternative, less burdensome approaches to restrictions on investment. In many instances, discussions were inspired by comparisons across the four professional fields considered, and by the positive experiences of OECD member countries which maintain more open markets for professional services while addressing adequately consumer protection and public interest concerns.

Among the approaches recommended by participants and subsequently supported by the OECD Council were the following:

- Incorporation should be permitted for professional services providers. Consumer protection concerns could be addressed through mandating minimum levels of capitalisation or professional insurance. Personal accountability of practitioners for their acts can be maintained, as can disciplinary action by professional associations.
- Non-professional investors, whatever their nationality, should be allowed to hold minority participation in firms, rather than being excluded from ownership altogether. This would still preserve professional control over the management of the enterprise, in order to ensure the quality of service and the independence of professionals with respect to outside interests. Appropriate shareholding diversification rules could be defined.

- Restrictions on investment by foreign-qualified professionals could be eased subject to adequate safeguards, such as an obligation on the foreign professional to hold membership in a recognised professional association or a requirement that at least one member of the board of directors be a locally-licensed professional.

Notes

1. Due to insufficient data availability, the figures do not include greenfield ventures in professional services. However, it can probably be assumed that mergers and acquisitions constitute the dominant form of FDI in these services sectors, both for legal and regulatory reasons (requirements for locally licensed or accredited professionals, language abilities, etc.) as well as the need to seek already established local expertise to develop in the particular field chosen.
2. For the full text and a User's Guide of the Codes, see *www.oecd.org/daf/investment* or OECD 2003 publications.
3. With regard to engineering and architectural firms, those providing consulting and advice, but not those providing construction services, are considered to fall within the professional services sector.
4. This applies unless the measures fall under the exception clause of Article 10 on preferential treatment with special customs and monetary unions.
5. However, restrictions on cross-border professional services are covered by the Current Invisibles Code.

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ANNEX 1

OECD Members' Restrictions to FDI in Professional Services Listed Under the OECD Code of Liberalisation of Capital Movements

Restrictions apply to:

Austria

- Investment by non-EC residents in accountancy services exceeding 49 per cent.
- Investment by non-EC nationals in legal services and in engineering and architectural services exceeding 49 per cent.

Belgium

- Investment by non-EC nationals in accountancy and legal services.

Denmark

- Investment in accountancy services by non-EC residents and in legal services by non-residents.

Finland

- Legal services: EC nationality and residency requirement for investment in a corporation or partnership carrying out the activities" "asianajaja" or" "advokat".
- Investment in auditing companies by non-EU residents.

Greece

- Investment by non-EC nationals in the accountancy, legal, engineering and architectural sector.

Mexico

- Investment by foreign nationals in legal services and private education services exceeding 49 per cent of equity, unless an authorisation is granted.

Norway

- Investment in the accountancy sector exceeding 49 per cent, and in the legal sector, by non residents.

Spain

- Investment originating in non-EC member countries in legal services.

Sweden

- Investment in the accountancy sector by non-EC residents exceeding 25 per cent.
- Investment in a corporation or partnership carrying out the activities of an" "advokat" by non-EC residents.

Turkey

- Investment in the accountancy sector.

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Chapter 5

Survey of Implementation of Methodological Standards for Direct Investment (SIMSDI)

The IMF and OECD have a well-established interest in foreign direct investment (FDI) statistics. OECD compiles and disseminates detailed FDI statistics for all OECD countries by partner country as well as by industry breakdowns according to a common framework in the International Direct Investment Statistical Yearbook*. IMF disseminates the FDI statistics of its member countries as a part of the balance of payments statistics according to standard components.*

Both organisations moreover publish methodological standards to measure the FDI activity. These guidelines are included in the IMF Balance of Payments Manual, fifth edition (the BPM5) *and the* OECD Benchmark Definition of Foreign Direct Investment, third edition (the Benchmark Definition)*. In 2001, the IMF and the OECD conducted, for the second time, a joint survey to assess the developments in the FDI statistics of their member countries (the first time was in 1997). This article summarises the main findings of the second joint survey.*

To monitor the challenges of an increasingly globalised economy, policy makers and investors need to perform regular analysis of foreign direct investment (FDI). To do so they need comprehensive, timely and internationally comparable statistics based on objective standards. The IMF and OECD have a well-established interest in FDI statistics. OECD compiles and disseminates detailed FDI statistics for all OECD countries by partner country as well as by industry breakdowns according to a common framework in the *International Direct Investment Statistical Yearbook*. IMF disseminates the FDI statistics of its member countries as a part of the balance of payments statistics according to standard components.

1. What is SIMSDI about?

Both organisations moreover publish methodological standards to measure the FDI activity. These guidelines are included in the *IMF Balance of Payments Manual, fifth edition* (*the BPM5*) and the *OECD Benchmark Definition of Foreign Direct Investment, third edition (the Benchmark Definition)*. In 2001, the IMF and the OECD conducted, for the second time, a joint survey to assess the developments in the FDI statistics of their member countries (the first time was in 1997). The Survey of Implementation of Methodological Standards for Direct Investment (SIMSDI) aimed at:

- determining the extent of the implementation of international standards in the statistical systems of member countries;
- obtaining standardised information from member countries on their practices for reporting FDI statistics as well as the data sources and the collection methods they use;
- facilitating bilateral exchange of information between countries;
- providing methodological information to the users of FDI statistics.

The results of the 2001 SIMSDI for 30 OECD countries[1] and 31[2] other IMF countries are analysed in a joint IMF/OECD report *Foreign Direct Investment Statistics: How Countries Measure FDI* (for an overview of the coverage, see textbox). The report serves as a comprehensive study of methodological standards applied by national compilers to measure FDI as well as their data sources and data collection and dissemination methods. It includes cross-country comparison tables and a glossary of terms and definitions. This work was conducted under the auspices of the IMF Committee on Balance of

Payments Statistics and the OECD Workshop on International Investment Statistics of the Committee on International Investment and Multinational Enterprises. It benefited from substantial contributions by national experts from member countries.

Individual survey results for 30 OECD countries are posted at the OECD web site *www.oecd.org/daf/simsdi* and summary metadata for all countries are posted at IMF web site *www.imf.org/bop*.

2. Key findings of the 2001 SIMSDI update[3]

2.1. Areas of significant improvement since the 1997 SIMSDI survey

Improvements in data availability. There has been a significant increase since the 1997 survey in the number of countries disseminating FDI statistics. The increases are most marked for the countries that are not OECD members, for FDI position data, and for inward FDI income data. In the four years between the 1997 SIMSDI survey and the 2001 update, an additional 13 countries began to report data on inward position data, an additional nine countries began to report data on inward FDI financial flows, and eight additional countries began to report data to the IMF on inward FDI income. A similar improvement was seen for the outward FDI statistics (FDI abroad), with an additional 14 countries reporting data on positions, an additional 10 countries reporting data on financial flows, and an additional six countries reporting data on income. Moreover, within the FDI income data, an additional 10 countries now report data on inward FDI income on equity, an additional 11 now report inward reinvested earnings, and an additional 10 now report inward FDI income on debt

During the same period there was a marked increase in the compilation of data showing geographic breakdowns, particularly for the FDI financial flows data, and the position data. An additional 11 countries now compile data showing geographic breakdowns for the inward FDI financial flows, and an additional 13 countries for the outward FDI financial flows. Similar improvements were seen for the FDI position data, with an additional 11 countries compiling geographic breakdowns for the inward positions, and an additional 12 for the outward positions. The increases in the number of countries that compile breakdowns for the FDI income data were not as marked–seven for the inward data and five for the outward data.

The compilation of data showing breakdowns by industrial sectors also increased markedly in the four years between the 1997 survey and the 2001 update. For the inward FDI statistics, an additional 11 countries began to compile industrial breakdowns for income, an additional 12 for financial flows, and an additional 11 for the position data. For the outward FDI

statistics, the increases were 10 additional countries for income, 12 for financial flows, and eight for position data.

Improvements in data coverage. The four years between the 1997 SIMSDI survey and the 2001 update saw significant improvements in the items covered by the FDI statistics, with a marked increase in the number of countries now following the recommendations of the international standards regarding the inclusion of data on the following aspects:

- *Non-cash acquisitions of equity, such as through the provision of capital equipment.* 51 countries now include non-cash acquisitions of equity in their data on FDI equity capital, an increase of 11 countries since the 1997 survey.
- *Inter-company loans and financial leases.* 56 of the 61 countries that participated in the 2001 SIMSDI update include long-term loans in their FDI statistics on other capital, an increase of 11 countries. In addition, the number of countries that include short-term loans in their data on FDI other capital increased by 10 to 51, and the number that include financial leases increased by 11 to 34.
- *Real estate owned by non-residents.* 48 countries now include purchases and sales of land and buildings by non-resident enterprises in their inward FDI transactions data, and 47 include these in their outward FDI transactions data, increases of 15 countries (eight OECD countries and seven other countries) in both instances. There have also been marked increases in the number of countries that include purchases and sales of land and buildings by non-resident individuals in their inward FDI transactions data–12 additional countries–and their outward FDI transactions data–13 additional countries.
- *Activities of Special Purpose Entities (SPEs).* There have been improvements in the inclusion of the activities of SPEs in the outward FDI transactions data of 12 countries, and in the inward FDI transactions data of eight countries for which SPEs were applicable, or for which SPE activities could be identified.
- *Activities of offshore enterprises.* There have also been improvements in the inclusion of the relevant activities of offshore enterprises in the outward FDI transactions data of 12 countries.
- *Expenditure on natural resources exploration.* An additional 11 countries now include expenditure on natural resources exploration in their inward FDI transactions data, and an additional 10 countries include these expenditures in their outward FDI transactions data.

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2.2. Areas where more than 75 per cent of the countries follow the recommendations

The results of the 2001 SIMSDI update show that there are now a number of areas where more than three quarters of the 61 countries that participated in the survey follow the international standards where they are applicable for their circumstances:

- **Use of the 10 per cent ownership rule for identifying FDI.** 90 per cent of the 61 countries use the 10 per cent ownership rule as their basic criterion for identifying direct investment enterprises in their inward FDI transactions data, and 82 per cent use the rule as the basis criterion for identifying direct investors in their outward FDI transactions data.
- **Inclusion of equity capital between affiliated banks and between affiliated financial intermediaries.** 93 per cent of the 58 countries for which the activities are applicable follow the international standards regarding the inclusion of equity capital transactions between affiliated banks and between affiliated financial intermediaries in their inward FDI transactions data.
- **Recording of reverse investment equity transactions when two FDI relationships have been established.** 82 per cent of the 51 countries for which reverse investments involving the acquisition of equity are applicable record the transactions in accordance with the international standards.
- **Inclusion of purchases and sale of real estate by non-residents.** 89 per cent of the 54 countries for which the issue is applicable include purchases and sales of land and buildings by non-resident enterprises in their inward FDI transactions data, and 75 per cent of the 53 countries for which the issue is applicable include purchases and sales by non-resident individuals.
- **Inclusion of data on activities of SPEs.** 93 per cent of the 42 countries for which SPEs are applicable, or for which SPE activities can be identified, include the relevant transactions of those SPEs in their outward FDI transactions data, and 88 per cent of the 40 countries for which SPEs are applicable, or for which SPE activities can be identified, include them in their inward FDI transactions data.
- **Inclusion of activities of off-shore enterprises.** 88 per cent of the 40 countries for which off-shore enterprises are applicable, or for which activities of off-shore enterprises can be identified, include the relevant transactions of those enterprises in their outward FDI transactions data, and 79 per cent of the 33 countries for which off-shore enterprises are applicable include the relevant activities in their inward FDI transactions data.

2.3. Areas where the majority of the countries surveyed do not yet follow the recommendations

Notwithstanding the improvements in the implementation of the international standards since the 1997 SIMSDI survey, the 2001 update identified the fact that there are still a number of aspects of the international recommendations that are not yet followed by the majority of the 61 countries that participated in the survey:

- **Inclusion of activities of indirectly-owned direct investment enterprises – use of the Fully Consolidated System (FCS).** Only 11 countries fully apply the FCS for their inward FDI transactions data, and there has been no change in this number since 1997. However, 28 countries partially apply the system, and a number of countries are unable to apply it because of difficulties in identifying all relevant indirect FDI relationships.
- **Use of the Current Operating Performance Concept (COPC) for measuring direct investment earnings.** Only 19 countries fully apply the COPC for measuring their direct investment earnings in their inward FDI statistics, and only 16 fully apply the COPC for their outward FDI statistics.
- **Time of recording FDI income on equity and income on debt.** Only 22 countries record income on equity (dividends and distributed branch profits) in their inward and outward FDI transactions data at the time they are payable, and only 25 record income on debt (interest) as it is accruing for their inward data and 22 for their outward data.
- **Recording of reverse investment transactions when the FDI relationship is in one direction only.** Of the 49 countries for which reverse investment transactions in one direction are applicable, only 17 record the acquisition of equity and 25 record the provision of loans in accordance with the international standards.
- **Inclusion of data on quasi-corporations involving construction enterprises and mobile equipment.** Only 23 countries include in their inward FDI transactions data the activities of quasi corporations involving construction enterprises. Even fewer include the activities of quasi-corporations involving mobile equipment such as ships, aircraft, and drilling rigs.
- **Valuation of FDI positions (assets and liabilities).** Only 21 countries value their inward equity capital positions at market values. Even fewer value their inward other capital positions and outward equity capital and other capital positions at market values.

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Box 1. **The coverage of the report**

FOREIGN DIRECT INVESTMENT: HOW COUNTRIES MEASURE FDI

Data

a. Data availability

- Data reported to the international organisations
- Periodicity of the disseminated FDI transactions data
- Timeliness of the disseminated FDI transactions data
- Periodicity of the disseminated FDI position data
- Timeliness of the disseminated FDI position data

b. Data sources

- sources for the FDI transactions data
- sources for the FDI position data

c. Geographic and industrial classifications

- Availability of geographic breakdowns of FDI statistics
- Principles used for the geographic allocation of FDI statistics
- Availability of industrial breakdowns of FDI statistics
- Basis used for industrial allocation of FDI statistics

Definition of direct investment enterprises and direct investors

a. Identification of direct investment enterprises

b. Identification of direct investors

c. Treatment of indirectly-owned FDI enterprises

Direct investment income

a. Measurement of direct investment earnings

b. Elements of direct investment income

c. Time of recording of direct investment income

d. Items included in the data on income on debt (interest)

Direct investment capital

a. Components of direct investment capital

- Items included in equity capital
- Items included in other capital
- Transactions between affiliated banks and between affiliated financial intermediaries

Box 1. **The coverage of the report** *(cont.)*

b. Reverse investment

- Treatment of reverse investment when the FDI relationship is in one direction only
- Treatment of reverse investment when two FDI relationships have been established

Valuation of assets and liabilities in the FDI position data

Special cases

a. Quasi-corporations: construction enterprises and operation of mobile equipment

b. Non-resident ownership of land and buildings

c. Activities of off-shore enterprises

d. Activities of Special Purpose Entities (SPEs)

e. Expenditure on natural resources

Notes

1. OECD member countries (also member of the IMF): Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.
2. Other countries members of the IMF which participated in the 2001 SIMSDI: Argentina, Bolivia, Botswana, Brazil, Chile, China, Colombia, Costa Rica, Croatia, Ecuador, El Salvador, Estonia, Guatemala, Hong Kong (China), India, Indonesia, Israel, Kazakhstan, Kuwait, Latvia, Lithuania, Malaysia, Nigeria, Peru, Philippines, Russia, Singapore, Slovenia, South Africa, Thailand, and Tunisia.
3. Extracts from the report *Foreign Direct Investment Statistics: How countries measure FDI*, IMF/OECD, 2003.

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