Chapter 12

Making the most of an open foreign investment regime

Main recommendations

The objectives of investment policy and investment facilitation efforts should be to:

- *Preserve a favourable investment regime by introducing periodic regulatory assessments to ensure that regulations continue to meet their intended purposes.*
- *Improve foreign direct investment (FDI) statistics and ensure that information is available to support policy formulation and appraisal.*
- *Review existing investment incentives in the light of current policy priorities and the potential for introducing new instruments to promote greater linkages of FDI with the broader economy.*
- *Streamline and clarify the roles, structure and interrelations among the various agencies involved in investment promotion and facilitation to establish their responsibilities in carrying out the functions of image building, investment targeting, linkage promotion and policy advocacy.*

An open investment regime and a robust regulatory and institutional environment have supported foreign direct investment (FDI) in Chile and made it an important driver of economic growth. The stock of FDI has tripled over the past decade. There are no prior-approval or screening requirements for FDI, and foreigners are legally granted the same treatment as nationals. Moreover, strong macroeconomic performance, strong and stable institutions and a generally friendly regulatory framework have enhanced the attractiveness of Chile as an FDI destination. As a result, Chile boasts one of the highest ratios of FDI to gross domestic product (GDP) in the OECD.

Nevertheless, FDI remains heavily concentrated in natural resources, potentially limiting beneficial spill-over effects on the broader economy in terms of innovation and productivity. Better data is needed to appraise the impact of FDI in specific sectors and efforts underway to improve data quality and coverage will aid in supporting the appraisal of linkages between FDI and the domestic economy.

Chile's approach to investment incentives has been broadly aligned with recognised best practices, eschewing specific incentives to attract FDI and/or special tax regimes, in favour of transparency and predictability. Chile already benefits from an open FDI regime, a solid regulatory framework and strong participation by foreign investors. In this context, investment facilitation policies can help fully exploit the potential benefits of foreign investment. Promoting linkages and targeting investments can help, but must be done right. Meeting that challenge will require a new approach to investment promotion and facilitation.

To meet this new challenge, government agencies involved in investment promotion and facilitation may need to adapt. The main instrument of investment facilitation, the DL600 contract, was introduced at a time when foreign investors still faced uncertainties for repatriation of capital and tax treatment, but is probably no longer needed. As Chile's macroeconomic and fiscal framework improved markedly over the past two decades, fewer and fewer investors sign DL600 contracts. As a result, investment facilitation in Chile could turn to face the challenge of fully exploiting the benefits that FDI can bring by enhancing linkages with the domestic economy. At an organisational level, better coordination may be needed to avoid duplication of tasks and clearly assign responsibilities for country image building, investment generation, linkage promotion and policy advocacy. Furthermore, the resources and skills needed to carry-out new investment facilitation tasks will call for adaptation of the relevant agencies to focus more on policies to attract investments from aboard with potentially strong spill-over effects and to strengthen their linkages with the domestic economy. These investment targeting policies can be useful to enhance the absorptive capacity of the domestic economy, but risks to public resources of targeting specific sectors and firms should be borne in mind. Chile's has distinguished itself by avoiding the pitfalls of special incentive schemes for foreign investment and any new programs should carefully balance costs and benefits.

Keeping markets open to foreign direct investment

Chile's liberal approach to the participation by foreigners in the economy is reflected in the absence of a specific law concerning foreign investment and of trans-sectoral restrictions, such as prior approval or screening requirements.[1] The principle of national treatment is incorporated in Chile's Constitution, which guarantees both Chileans and foreigners the right to develop any economic activity, provided applicable legislation is observed and such activities are not contrary to public morals and order, or to national security interests.

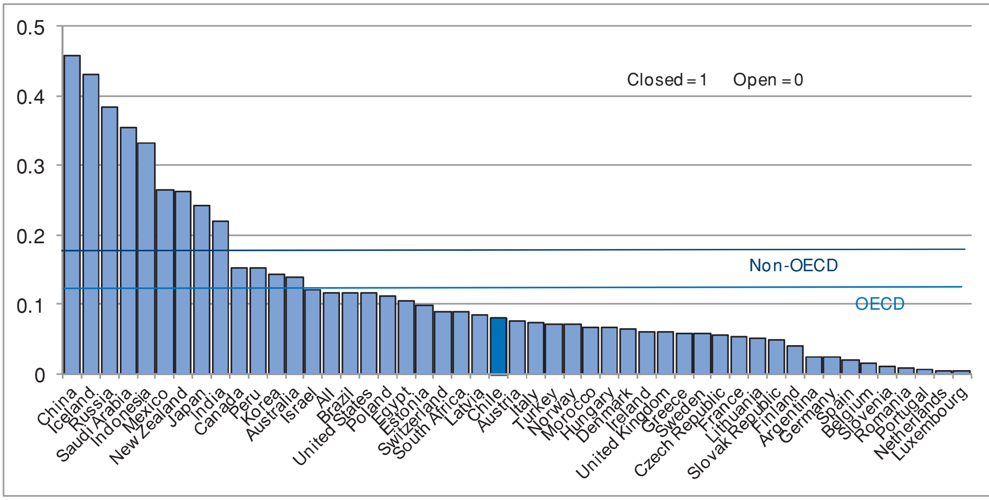
Restrictions on foreign entry apply only to a few sectors (air and maritime transport, radio broadcasting and fishing vessels) and rules for granting of concessions make no distinctions between nationals and foreigners, ensuring openness to foreign investors in sectors such as mining (accounting for around one-fifth of GDP) and telecommunications, in which a concession is required.[2] Chile is open to foreign investment in the financial sector. Branching is allowed in banks and insurance, but establishment of all other types of financial institutions requires incorporation in Chile.

Chile's openness to FDI is reflected in its score on the OECD FDI Restrictiveness Index, which assigns higher numbers to regulations that are discriminatory towards foreign investors.[3] The overall score is lower for Chile than for the average of OECD countries (see Figure 12.1), and restrictions tend to fall into sectors that also are more restricted in other OECD countries.

FDI rules are a critical determinant of a country's attractiveness to foreign investors, and Chile has benefited from low restrictiveness. Indeed, Chile's FDI performance has been somewhat better than that of countries with a similar degree of restrictiveness, suggesting that other factors have also been at play (see Figure 12.2).

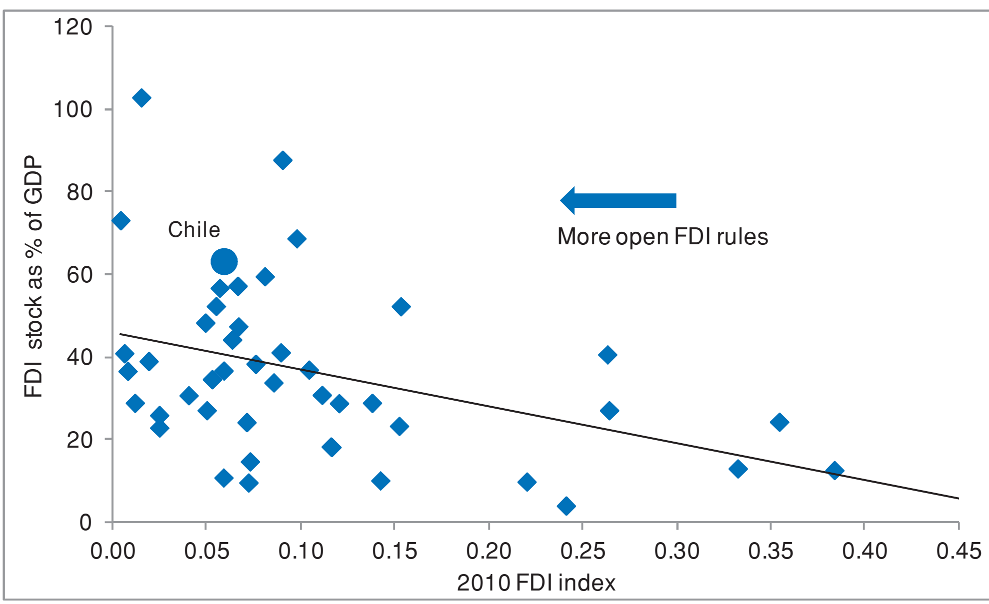
Natural resource endowments have played a role, as mining has been the main recipient sector by far, with one third of total inflows over the period 1990–2008, followed by electricity, gas and water supply (22%), financial services (13%), manufacturing (12%) and communications (10%). However, more in-depth analysis of the distribution of FDI and its impact on specific activities is needed to assess the importance of resource endowments. In natural resource based activities such as fish farming and fresh fruits, Chile has been successful in moving from mere resource extraction to activities with higher value added. Furthermore, more and better data are needed for such analysis, in particular regarding the distribution of FDI inflows by sector, as currently data coverage is partial.[4] Chilean authorities have established a timetable for full implementation of the 4th edition of the Benchmark Definition of FDI, which will bring their FDI statistics up to international standards.

Figure 12.1. **Country scores for the 2010 FDI Restrictiveness Index**



Source: Kalinova, B., A. Palerm and S. Thomsen (2010),"OECD's FDI Restrictiveness Index: 2010 Update", *OECD Working Papers on International Investment*, No. 2010/03, DOI: *10.1787/5km91p02zj7g-en*

Figure 12.2. **Country scores for the 2010 FDI Index and FDI Performance**



Source: Kalinova, B., A. Palerm and S. Thomsen (2010),"OECD's FDI Restrictiveness Index: 2010 Update", *OECD Working Papers on International Investment*, No. 2010/03, DOI: *10.1787/5km91p02zj7g-en*

Ensuring a favourable regulatory and institutional framework

The attractiveness for foreign investors of an environment of strong economic growth and stability has been complemented by the strength of the broader regulatory and institutional framework and by public policies that have sought to ease the regulatory burden on business and accommodate Chile's increasing international economic engagement.

In recent years Chile has improved the framework for intellectual property rights (IPRs) and for competition policies. During the past decade, legal, administrative and institutional reforms have been introduced and international engagements have been entered into to provide protection for IPRs. Chile's open environment for foreign investment is also supported by competition policies, which have promoted economic efficiency to maximise consumer welfare in the long run. To fulfil its stated purpose of promotion and defence of free market competition, Chilean competition law has a broad scope of application and, in general terms, there are no exclusions or exemptions required or authorised under it or under any other regulation. The competition regulations apply to nationals and foreigners, private and public entities, and goods and services. There is no special treatment for state-owned or managed enterprises, as these entities are subject to enforcement under the same terms applicable to private enterprises. In addition, the law explicitly forbids the granting of concessions or authorisations by the government that could create a monopoly, unless specifically allowed by law.

Foreign investors, once established in the country, benefit from legal protection of property rights. Private property rights are fully protected under the Constitution and property may be expropriated only pursuant to specific constitutional provisions: expropriations may be executed only by a law approved by the legislature, on grounds of public benefit or national interest, and the expropriated parties have the right to compensation for material damage, which is to be established by mutual agreement or by ruling issued by the courts.

To ensure transparency and accountability in the making and implementation of laws and regulations affecting foreign investment, mechanisms are in place to provide for public consultation prior to regulatory changes. The Chilean Constitution establishes that all actions of the state are public; thus all procedures must be made public, including the process of preparing new legislation. Furthermore, the Law on the Basis of Administration of the State provides that, prior to the issuance of regulations, all regulators have the obligation to publish the proposed regulations on their website and receive comments and petitions.

There are several features of Chilean legislation that further protect interests of investors and the public at large. The use of "silence means consent" in administrative procedures was introduced by a legislative change in 2003. Recent reforms to financial legislation have expanded its use to the approval of licences in banking, insurance and pension fund management. Furthermore, investors have recourse to judicial redress if they think that a decision by an authority has affected the exercise of legal rights.

While Chile still has to make more progress on the development of periodic regulatory impact assessments to ensure that regulations continue to meet their intended purposes and are proportionate to the objectives pursued, authorities maintain an active exchange of information with interested parties regarding the regulatory framework, which allows them to evaluate the costs and benefits of measures taken.

Avoiding the pitfalls of special incentives

Tax incentives in Chile do not, in general, distinguish between foreign and domestic owned enterprises. This principle of non-discrimination is set out in law. Chile has made efforts to simplify, unify and eliminate special incentives schemes. Remaining incentives schemes that benefit only foreign investment comprise Decree Law 600 (DL600), Foreign Investment Capital Funds (FICEs), the Investment Platform Law, the Program for Hi-Tech Investment, and facilities for financial market and real estate investments by non-residents.

The special and voluntary regime of DL600, administered by the Foreign Investment Committee, offers foreign investors the option to enter into a legally binding contract with the Chilean State that provides guarantees regarding taxation and transfer of capital and profits. The DL600 does not provide "tax breaks" or "tax holidays", but are intended to provide a stable tax horizon, acting as a form of "tax insurance" to lock into the specific tax provisions prevailing at the time the investment is made. Furthermore, investors acquire a right to remit profits at any time; subject to a one year lock-in to repatriate capital. These guarantees have lost their appeal in the context of greater fiscal stability and the current regime of complete freedom of international payments and transfers. The share of FDI projects covered by DL600 has gone down from over 95% before the removal of exchange controls in 2001 to less than 10% in 2007. The Foreign Capital Investment Funds (FCIFs) have provided a similar system for portfolio investments in Chile.

The Investment Platform Law aims to promote Chile as a regional base for multinational companies, by providing tax-free status to earnings from international (non-Chilean) operations. At the same time, there are provisions designed to avoid Chile becoming a tax haven and to prevent domestic entrepreneurs from eluding the payment of domestic taxes. The Chilean operations of these companies are taxed under the regime that normally applies to foreign investment.

The Program for Hi-Tech Investment seeks to attract foreign investment in high technology projects in Chile by providing subsidies for pre-investment costs and human capital development. To qualify, investments must promote the development and use of new technologies in the fields of information and communication technology, biotechnology, new materials, electronics and engineering in processes. Also eligible are firms that use new techniques when producing or adding value to abundant natural resources. The subsidies come from the budget of Chile's development promotion agency, the Corporation for Fostering Production (Corfo).

Enhancing investment facilitation

Chile's investment regime is a noteworthy example of application of some of the basic tenets of the OECD's *Policy Framework for Investment* (PFI) (2006a) regarding investment promotion and facilitation.[5] However, the framework for investment facilitation in Chile may still be overly geared towards issues that are no longer the main priority for public policies. An assessment of what is being done would help develop reform proposals of policies and agencies, in order to align them with priorities for public policies in this area. The PFI provides an aid that can help guide such an assessment. The text of the PFI on investment promotion and facilitation and the nine questions on this topic are presented in Box 12.1. *The PFI: A Review of Good Practices* (OECD, 2006b) presents related recommendations and country experiences; they have been used to inform the discussion on certain key issues for the case of Chile.

A sound, broad-based business strategy is the starting point for investment facilitation. The PFI's Annotations point to the role of specific measures to promote and facilitate investments "within the context of, and not to substitute for, broader policies for improving the investment environment". Chile has a favourable business climate and solid institutional framework that could be complemented by measures to highlight profitable investment opportunities and help identify local partners, while avoiding the pitfalls of special incentives.

Structure, role and legal status of the investment promotion agency (IPA). In the case of Chile there are several agencies involved: the Foreign Investment Committee, the Investors Relations Office of the Ministry of Finance and CORFO – Chile's development promotion agency. The Foreign Investment Committee is Chile's IPA. It also administers the old DL600 regulations that played an important role in facilitating foreign investment when Chile still had exchange control regulations in force.

Box 12.1. **Policy Framework for Investment: investment promotion and facilitation**

Investment promotion and facilitation measures, including incentives, can be effective instruments to attract investment, provided they aim to correct market failures and are developed in a way that can leverage the strong points of a country's investment environment.

1. Does the government have a strategy for developing a sound, broad-based business environment, and within this strategy, what role is given to investment promotion and facilitation measures?

2. Has the government established an investment promotion agency (IPA)? To what extent has the structure, mission and legal status of the IPA been informed and benchmarked against international good practices?

3. Is the IPA adequately funded and is its performance in terms of attracting investment regularly reviewed? What indicators have been established for monitoring the performance of the agency?

4. How has the government sought to streamline administrative procedures to quicken and to reduce the cost of establishing a new investment? In its capacity as a facilitator for investors, does the IPA take full advantage of information on the problems encountered from established investors?

5. To what extent does the IPA promote and maintain dialogue mechanisms with investors? Does the government consult with the IPA on matters having an impact on investment?

6. What mechanisms has the government established for the evaluation of the costs and benefits of investment incentives, their appropriate duration, their transparency and their impact on the economic interests of other countries?

7. What steps has the government taken to promote investment linkages between business, especially between foreign affiliates and local enterprises? What measures has the government put in place to address the specific investment obstacles faced by SMEs?

8. Has the government made use of international and regional initiatives aimed at building investment promotion expertise, such as those offered by the World Bank and other intergovernmental organisations? Has the IPA joined regional and international networks?

9. To what extent has the government taken advantage of information exchange networks for promoting investment?

Source: OECD (2006a), *Policy Framework for Investment*, OECD Publishing, DOI: *10.1787/9789264018471-en*.

In addition to these agencies, in November 2009 a new non-profit organisation (InBest) was formed under the advocacy of the Ministry of Finance with the aim of promoting the Chilean market's strengths and advantages in financial services before the international financial community. InBest is also a permanent communication channel for non-Chilean investors, the most important Chilean securities' issuers and other participants in the Chilean capital markets, including governmental authorities.

Streamlining and clarifying the roles and interrelations among the various agencies is an important element in establishing their responsibilities in carrying out the functions of image building; investment generation; linkage promotion and policy advocacy.

For IPAs that are starting their investment facilitation efforts, image building and the dissemination of information may be important first steps. Understanding what an investor may be seeking and the advantages the country may have to offer is a first step. IPAs of countries such as Chile that are already significant FDI recipients can focus on other tasks, including investment facilitation and policy advocacy.

The trend among IPAs regarding investment facilitation has been to focus more on targeting of investments, rather than on granting of special incentives (OECD, 2006b, p. 36). Such targeting of industries or individual firms may bring benefits, but also entails risks, not least because picking winners has always proven difficult and giving preferences to firms may have negative implications for competition.

Identifying the country's advantages and market opportunities is a first step in developing a sound pro-active strategy. In the case of Chile, where FDI has been closely linked to natural resource endowments, there may be opportunities for FDI into new sectors in which foreign investors' potential for innovation can help open new clusters of activity. The opening of such new investment areas may require a specific role of the IPA in identifying opportunities and in acting as an advocate for putting in place regulations and public goods needed to support a specific activity.

Targeting investment opportunities and linkage promotion can also help in this context, if properly done. Such efforts can reduce the cost of gathering information about opportunities for investors, bringing to the country technology and international linkages that are not available locally. Local cost discovery can be a barrier to the unleashing of investment opportunities (see Hausmann, Hwand and Rodrik, 2005). Investment targeting can play a role in overcoming these barriers. However, to be effective, it requires having the capacity to identify those "particular advantages that the broader international investment community might not be aware of" (OECD, 2006b, p. 36).

Resources needed by IPAs and monitoring of performance. The structure and functions of the Foreign Investment Committee in the past have been largely structured around its role as administrator of DL600 contracts. These duties include the registration of investments and follow-up on contractual obligations. These tasks are quite different from those of investment promotion, linkages and advocacy for FDI within government that been mentioned above. Efforts to further pursue investment targeting by Chile's IPA, the Foreign Investment Committee, are likely to require different skills and talents.

To be successful, IPAs need funding; they also need links with the centre of government and private sector visibility to be effective. In Chile there is the further need for a clear cross-agency coordination regarding strategies and priorities with other relevant government agencies such as Corfo, Chile's development promotion agency, which has responsibility for the Program for Hi-Tech Investment which provides funds for pre-investment studies, project start-up and investment in fixed assets and human capital.

The IPA as an advocate for FDI. The PFI also points to the role of the IPA within government. While Chile does have public consultation mechanisms for the development of all laws and regulations, there can be an added benefit of having the IPA operate as an advocate for FDI issues within government. This is particularly important in the context of efforts to target investments that can open up new areas of opportunity that do not yet exist in the country. The new activities may generate specific needs in terms of training of workers or use of infrastructure; they may also call for new regulations or standards needed to support the new activities.

Periodic assessment of incentives. On the use of incentives, Chilean practice has been closely aligned with PFI recommendations on good practice. Chilean law excludes the possibility of granting more privileged tax treatment to foreign investors. The absence of special incentives for foreign investors can be counted as one of the most noteworthy aspects of Chile's investment regime, one which bolsters the overall coherence of the policy framework. Special incentives frequently distort broader incentive structures while bringing meagre benefits. By focusing on enhancing the overall institutional and regulatory framework, countries can boost both the absolute amount of dollar inflows and the impact those investments have on economic and social well-being.

Furthermore, Chile adhered in 1997 to the Decision on International Investment Incentives and Disincentives by which adhering countries recognise the need to give due weight to the interest of other adhering countries affected by laws and practices in this field; endeavour to make measures as transparent as possible; and are prepared to consult one another on the above matters.

As a result of efforts to simplify, unify and eliminate special incentives, Chile maintains few and limited schemes that benefit only foreign investors. Of those that remain in force, the DL600 and the FCIFs did play a prominent role as a means of mitigating risks faced by foreign investors regarding changes in tax treatment and/or repatriation of capital. The latter were important in the period during which Chile still maintained exchange controls and faced less certain fiscal prospects than today. However, investor interest in these schemes has diminished over the years.[6]

The Chilean authorities' policy is to ensure that special tax and other incentives to attract investment are subject to periodic net cost-benefit assessments and that they are not maintained for longer periods than necessary. This item acquires particular relevance in the context of more pro-active investment-targeting efforts, as it provides a means to contain the downside risks of such policies. *The PFI: A Review of Good Practices* (OECD, 2006b) provides a checklist for incentive policies that can be used to carry out such assessments.

Facilitating linkages. Facilitating linkages is one way for governments to increase the absorptive capacity of the economy to benefit from technology transfer from foreign enterprises, and the PFI calls for an examination of government action in this area. Education and training to meet the evolving skills of industry have worked better than performance requirements or direct technology transfer obligations (OECD, 2006b, pp. 43-44). More flexible systems have replaced performance requirements to stimulate linkages with the local economy and SMEs, including programs that provide incentives to foreign investors to engage in capacity building among local suppliers.

Building linkages between the domestic economy and foreign firms is important, but potential risks should not be overlooked. Policies to enhance the absorptive capacity of the domestic economy through training and human capital development are superior to "picking winners" and to direct technology transfer requirements.

Using international resources. International initiatives provide governments with a wide array of resources to build investment promotion expertise and access to information networks to promote linkages between domestic and foreign business partners. The full use of these resources can greatly expand local capacity in enhancing investment facilitation and promotion.

The PFI: A Review of Good Practices stresses the positive role of investment promotion and facilitation measures when multinational enterprises are slow to spot profitable investment opportunities or hesitate before using local suppliers. It also points to the importance of focusing on existing investors, by learning from the problems they face and being an advocate for change within government, as much as of attracting potential new investors. Targeting of investment should be based on a sound assessment of advantages and opportunities, as well as of underlying risks. The impact of FDI on the broader economy is a matter of inflows as much as it is about linkages and "[l]inkages depend first and foremost on the quality of local human capital and on the domestic policy environment" (OECD, 2006b, p. 48).

Notes

1. Chile does maintain a national security-related measure regarding the acquisition of real estate by foreigners in certain geographic areas.
2. There is an exception to this rule in the case of certain mining activities, for which prior authorisation is required because of national security concerns.
3. The FDI Index looks at the four main types of restrictions on FDI: foreign equity limitations; screening or approval mechanisms; restrictions on the employment of foreigners as key personnel; and operational restrictions such as on branching, capital repatriation or land ownership. For further details, see Kalinova, Palerm and Thomsen (2010).
4. There are two sources of FDI data: the Central Bank of Chile and the Foreign Investment Committee. The Central Bank provides estimates of total net flows of FDI in Chile and of net flows of Chilean direct investment abroad, as part of the procedures to compile balance-of-payments data. Sectoral and country breakdowns in the Central Bank data are currently available only for outflows. The Foreign Investment Committee maintains a record of all foreign investments covered by DL600 contracts, and these records provide the only source of information currently available regarding the country of origin and the sector of destination for inflows. However, as the share of total FDI coming into Chile under this type of contract has diminished, the coverage of this source has deteriorated substantially.
5. See OECD (2006a). Chile was one of the co-chairs of the task force that developed the Policy Framework for Investment, bringing together the experiences of some 60 governments and in collaboration with the Investment Committee and 9 other OECD bodies (the DAC, the Trade Committee, the Competition Committee, the Committee on Fiscal Affairs, the Steering Group on Corporate Governance, the Education Committee, the Employment, Labour and Social Affairs Committee, the Working Group on Bribery in International Business Transactions, and the Public Governance Committee). The World Bank, UNCTAD and other international organisations, as well as non-governmental organisations, participated in task force meetings and provided input.
6. In November 2010, the Foreign Investment Technical Committee was established to co-ordinate the activities of the various entities that deal with investment promotion in order to generate a unified

strategy. The committee is presided by a respresentative of the Foreign Investment Committee and brings together representatives from InvestChile Corfo, Direcon and ProChile.

Further reading

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Kalinova, B., A. Palerm and S. Thomsen (2010),"OECD's FDI Restrictiveness Index: 2010 Update", *OECD Working Papers on International Investment*, No. 2010/03, DOI: *10.1787/5km91p02zj7g-en*.

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