GOVERNANCE AND THE FOREIGN DIRECT INVESTOR

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1 INTRODUCTION

At its spring 1991 meeting the Development Committee of the World Bank and the IMF requested a report on 'an overall legal framework which would embody the essential legal principles so as to promote FDI (foreign direct investment)'. Preparation of this report was entrusted by the President of the World Bank to a task force consisting of the General Counsel of the World Bank (as chairman), the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA).

In fulfilment of the request, the task force published 'A Survey of Existing Instruments' constituting the 'Legal Framework for the Treatment of Foreign Investment', which sought to identify general trends in the prevailing use of these instruments. A second document was then prepared comprising a draft report to the Development Committee which incorporated a set of 'Proposed Guidelines'. This document builds upon the trends identified in the first document but also takes into account what have been identified as 'prevailing best practices' by the World Bank Group as well as the need to ensure 'broad international acceptability'.

The potential influence and importance of the Guidelines should be obvious. At a time when so many LDCs are declaring it to be their intention to give a more prominent role to private sector activities, and when the role of FDI in private sector modernization and growth is also being strongly urged, Guidelines promulgated by the Development Committee are very likely to become something approaching the required standard practice. At the very least they will be universally quoted as the prime reference point as to what constitutes good governance in this area of the state's activity.

This article proceeds as follows. Part 2 summarizes the contents of the proposed Guidelines. Part 3 sets out the range of undertakings and concessions which have often been included in a LDC government's Foreign Investment Code. Certain differences between the Guidelines and what we have characterized as a representative Code will be noted, but one striking similarity is urged as being of greater importance. Because of the terms of reference given to the task force, the Guidelines, even more than most Codes, concentrate upon a rather narrow range of legal issues and instruments. There is some danger in this. It is that political leaders in certain developing countries wanting to undertake market-led reforms will put in place all the instruments recommended in the Guidelines, and then feel dismayed and poorly-advised by what follows — or fails to follow.

One can imagine only too easily the reaction: 'We have done everything the Bank and the Fund urged us to do. We have opened up our economies and introduced these shining new investment Codes with all the recommended provisions — but still the foreign investment does not come, or comes only in a trickle'.

The ambitions of Parts 4 and 5 are to broaden the perception after injecting a dose of realism into anyone who might think that adherence to the Guidelines by itself would be sufficient to satisfy most potential foreign investors. Specifically Part 4 lists 22 additional concerns that will be present in the investor's mind, many of them more pressing than the items included in the Guidelines. Part 5 suggests (if only by implication) that the Development Committee should request a report on the governance of the world economy, and a code of conduct for international economic relations. Improvements in these areas, it is argued, would do more to encourage beneficial investment in the less developed economies than even the wisest legal Guidelines or Codes.

2 THE GUIDELINES

The Guidelines are professedly legal in character and attempt to do no more than set out a framework of principles that the individual host state may then embody in its own laws, agreements, treaties, regulations, etc. They do not, for instance, involve themselves in issues relating to the preservation of national culture (including the pattern of consumer tastes), immigration, the distribution of domestic income, or the appropriate dividing line between the public and private sector. It is assumed that host governments desire inward foreign investment and that inward investors will comply completely and in good faith with all local legal requirements. Nothing more is said regarding the appropriate conduct of foreign investors in the host state on the grounds that a set of rules for this purpose has already been reflected in negotiated provisions of the United Nations Centre on Transnational Corporations (UNCTC) draft Code of Conduct.

The main areas which are covered are: (a) the admission of foreign investment; (b) the treatment of foreign investment, particularly in respect of the transfer of capital and returns; (c) expropriation and unilateral alterations or termination of contracts; and (d) the settlement of disputes. In the following sections the proposed Guidelines are summarized under these four heads.

A The admission of foreign investment

Each state is expected to encourage and facilitate the investment in its territory of capital, technology and managerial skills by nationals of other states, whether corporate or individual. Procedures, regulations and conditions may be made by the host state governing FDI, but these should not be unduly cumbersome or complicated. Experience suggests (say the Guidelines) that performance criteria such as minimum local ownership, local employment or export targets, although perceived to be in the national interest, are often counterproductive in that they either discourage foreign investors or give rise to evasion and corruption. Unrestricted admission, save for certain listed investments which would either be prohibited or would need screening and licensing, is commended as a more effective approach. Notwithstanding this general approach, a state may reserve certain investments for its own nationals or may refuse a proposed investment considered to be contrary to the interests of national security, public health or public order, the protection of the environment, or simply unconducive to its economic development. Each state is encouraged to publish and publicize regularly-updated information regarding its legislation, regulations and procedures affecting FDI, including an indication of those classes of investment which are prohibited, subject to screening and licensing, or reserved for nationals.

B The treatment of private foreign investments

The first underlying principle proposed is that, in respect of the legal protection of their person, their property (including intellectual property) and their rights and in the grant of permits, licences, authorizations, visas, etc., the treatment of foreign investors should not be less favourable than that accorded by the State to national investors. In similar vein, the host State should not discriminate among foreign investors on grounds of nationality. The second underlying principle is that the State should not refrain from doing anything within its own competence that may be necessary for the efficient and uninterrupted operation of the approved investment. This extends to the prompt issuance of licences and permits, and authorization for the employment of foreign personnel — although the State may reasonably require the investor to establish his inability to recruit locally before he resorts to recruiting abroad.

With regard to the transfer of funds abroad, the host State should freely allow transfer of the net revenues realized from the investment (subject to the exceptions authorized under the Articles of Agreement of the IMF or in relevant treaties) and of such sums as may be necessary to discharge all due obligations, including the servicing and repayment of contracted debts. On liquidation or sale of the investment, the investor should be allowed to repatriate the proceeds immediately or, where the State faces foreign exchange stringencies, over a period not exceeding five years with interest at the normal commercial rate accruing upon retained funds until such time as the transfer is actually effected. Foreign personnel employed should be allowed to transfer regularly a reasonable part of their salaries and wages and, upon termination of their employment, should be allowed an immediate transfer of all savings from such salaries and wages. The Guidelines make it clear that the transfers provided for above should be made at the market rate of exchange at the time of the transfer.

Consistent with much modern advice, the Guidelines do not suggest that a host State should provide foreign investors with tax exemptions and other fiscal incentives. Reasonable and stable tax rates are considered to provide a better incentive. Competition amongst host States in providing tax exemptions is particularly deplored. Again in line with most modern thinking, where incentives are deemed to be justified, the advice is that they should preferably be granted automatically, linked to the type of activity which the State particularly seeks to encourage, and should be available equally to national investors in similar circumstances. As something of an afterthought, the Guidelines do commend fiscal incentives that are provided by the investors' own government (presumably an OECD country) for the purpose of encouraging investment in developing countries.

C Expropriation and unilateral alterations or termination of contracts

The Guidelines state that a host State may not expropriate or nationalize in whole or in part a foreign private investment, or take measures which have a similar effect, except where this is in pursuance in good faith of a public purpose, is done in accordance with applicable legal procedures without discrimination on the basis of nationality and against the payment of appropriate compensation. Most of the rest of this section deals with a discussion of what principles should be applied to determine that such compensation is 'appropriate'.

Compensation will generally be considered appropriate if it is based upon the fair market value of the asset taken and is paid without undue delay. But how is 'fair

market value' to be determined in the absence of an actual agreed sale between a willing buyer and a willing seller?

The Guidelines suggest three different criteria. For a going concern with established profitability, fair value may be based on a discounted net cash flow calculation taking account of risk, the expected rate of inflation and the time value of money. The rate of return available in the same market on investments of a comparable character may also be taken as a guide. For an enterprise which has not been profitable, liquidation value (i.e. the realizable value of the assets minus unavoidable liabilities) may be used. For other nationalized assets — those which are neither steadily profitable nor consistent loss-makers — fair market value may be estimated on the basis of the replacement cost of the assets taken or, if a market valuation has recently been written into the accounts, on the basis of book value.

Compensation should also be effective, in the sense of being paid in a currency of use to the investor, and paid either promptly or, if the State faces foreign exchange difficulties, in instalments over a period not exceeding five years provided that market-related interest in the currency of compensation should apply to all deferred payments.

Where comprehensive non-discriminatory nationalizations are embarked upon under circumstances of war, revolution or similar exigencies, the Guidelines suggest that compensation may be more appropriately determined by government-to-government negotiations (between the host State and the investors' home States) rather than through negotiations with individual companies. Should such government-to-government negotiations fail, international arbitration is proposed.

D Settlement of disputes

The Guidelines state as a matter of observed fact that most disputes between private foreign investors and the host State are settled by negotiation between them, through recourse to the host State's courts or through other agreed mechanisms.[1]

The Guidelines in fact stop short of recommending that host States agree to independent arbitration (which, in the circumstances of a FDI will normally mean international arbitration) should local remedies fail. What they do instead is to define independent arbitration as a process agreed to by the State and the investor or between the host State and the investor's home State where the majority of arbitrators are not solely appointed by one party to the dispute. Where independent arbitration is agreed to, the Guidelines encourage states to have recourse to the International Centre for Settlement of Investment Disputes (ICSID) if the State is a party to the ICSID Convention, or to seek arbitration through the 'ICSID Additional Facility' if the host State is not a party to the ICSID Convention.

What are we to make of these guidelines emanating from one of the world's most powerful and influential institutions? A first impression is how stilted and narrow they are. Well, any document drafted mainly by lawyers responsible to an international constituency is likely to be stilted and, in some places, deliberately ambiguous. A major reason for the Guidelines' narrowness stems from their concentration almost entirely upon a restricted range of legal instruments rather than upon a State's policies and the wider culture of the host country's society. In this they duplicate the provisions of most developing countries' 'Investment Codes' and may well be running the danger of inspiring a similar sense of disappointment and disillusion.

But there is another reason why the document conveys an impression of narrowness, or lack of historical depth. Certainly it is the current prevailing wisdom within the Washington institutions that a greater flow of FDI will benefit the world in general and the economics of developing countries in particular, 'improving the long term efficiency of the host country through greater competition, transfer of capital, technology and managerial skills and enhancement of market access'. These surely are matters of considerable potential benefit. But intellectual fashions have a habit of going too far, and it is perhaps as well to remind ourselves that enthusiasm for large-scale international financial flows has not always been unmitigated — even by those who played a large role in founding those same Washington institutions.[2]

3 INVESTMENT CODES

A typical code, with its accompanying legislation and guide, would be likely to include the range of undertakings and concessions indicated in Table 1.

[1] What the Guidelines do not state is that just because a settlement is eventually agreed, that does not mean that the outcome is regarded as fair or satisfactory either by the government or by the investor; it is just as likely to mean that the costs of extending the dispute are regarded by at least one party as potentially unbearable.

[2] Keynes, who played such a large role in founding those same institutions, once wrote: 'I sympathize, therefore, with those who would minimize rather than those who would maximize, economic entanglements among nations. Ideas, knowledge, science, hospitality, travel — these are the things which should of their nature be international. But let goods be homespun wherever it is reasonably and conveniently possible, and, above all, let finance be primarily national'.

Table 1

	Item	Concession Offered
1	Importation of essential machinery and equipment	(a) automatic import permissions accorded; (b) exemption from import duties for plant and equipment; (c) duties rebated on imported materials used for production that is subsequently exported;
2	On value of investment	(a) initial investment allowance; (b) accelerated depreciation;
3	On taxable income	(a) tax holiday or partial rebate of tax; (b) permission to carry forward capital allowances to beyond tax holiday period; (c) indefinite carry forward of losses;
4	Social security contributions	(a) rebate of income tax to extent of social security contributions paid on behalf of local employees;
5	Stamp duty and property rates	(a) deferment or partial rebate;
6	Access to domestic loans and credit	(a) an approved foreign investment will be permitted to raise finance from domestic sources in proportion to the size of the foreign capital provided;
7	Foreign earnings	(a) permission to operate an external account; or (b) an externally-denominated account at Central Bank;
8	Retentions	(a) right to retain a certain proportion of foreign earnings in an external account;
9	Expatriate personnel	(a) automatic visas and work permits for approved number of expatriate personnel; (b) proportion of remuneration allowed to be remitted; (c) value of certain approved benefits and allowances not subject to income tax, or taxed at a reduced rate; (d) savings accumulated out of local earnings can be repatriated at end of contract; (e) exemption from Alien Employment Tax for expatriates working on priority projects;
10	Applicable tax rate	(a) a guarantee that the tax rate applicable to the income of the enterprise will not rise above a stipulated rate;
11	Transfer of dividends, interest, fees, capital, etc.	(a) guarantee of full remittability of profits attributable to the investment and of dividends declared; (b) guaranteed transfer of full servicing payments for approved foreign loans; (c) remittability of royalties, fees, charges for technology transfer as provided for by the Investment Code; (d) permission to remit capital in the event of sale or liquidation of the enterprise, or of an interest in it attributable to foreign investment;
12	Tariff protection	(a) if all or part of the production is destined for the domestic market, the enterprise may be offered tariff protection against imports for a specified number of years;
13	Exclusive licensing	(a) establishment or production license will be granted as appropriate; (b) where the industry qualifies for pioneer status (i.e. produces a product new to the country), an undertaking may be given that no further license for production of the same product will be issued for a stipulated number of years;
14	Guarantee against expropriation	(a) no enterprise approved under the code shall be expropriated or nationalized; (b) no person owning all or part of the capital of approved enterprise shall be obliged to part with the interest to another person;
15	Spoliation	(a) the investor may have recourse against the government in the local courts in the event of the terms under which the enterprise operates being changed in a discriminatory manner to the disadvantage of the investor;
16	Settlement of disputes	(a) in the event of a dispute with the government not being settled through amicable negotiation or satisfactorily through domestic disputes settlement procedures, the dispute will be submitted to binding international arbitration.

There are a number of significant contrasts between the approach and content of the Guidelines and those of a representative Foreign Investment Code (FIC). The traditional FIC approach requires that **all** foreign investment should be submitted to government and need various approvals before the investment can be made, quite apart from being necessary to gain any of the proffered benefits or concessions. In line with the general reappraisal of the importance of private sector activities, the modern approach is to welcome the inward investor of capital for any business activity which is not prohibited by law, and not specifically reserved for government or for nationals of the country. No special consents or permissions would be required for any such investment (any more than they would be in the USA or the UK). Only if the foreign investor seeks assurances or concessions which are not available to the local investor (say on repatriation of profits and capital, or settlement of disputes) does he need to make application before making his investment. If such assurances or concessions are granted, the foreign investor may also be required himself to give certain assurances or to abide by certain conditions (e.g. on training and employment of nationals) that would not be imposed on the domestic investor. Otherwise the trend is to treat foreign and domestic investors on level and even terms, neither extending any special concessions to foreign investors that are not available to domestic investors in the same sector nor discriminating against the foreign investor.

It is a corollary of this approach that the Guidelines come down against special tax holidays, accelerated allowances, etc. for foreign investors only.

In those countries which are in the throes of a transition from being centrally planned, command economies into economies encouraging greater private ownership and use of market mechanisms, a different situation arises. Such societies do not already have in place any sophisticated legal structure for dealing with private sector business. For that reason China has felt the need, since first welcoming foreign joint ventures in 1979, to promulgate over a hundred statutory instruments — some described as laws and some as regulations — dealing not only with taxation and fiscal incentives but also such topics as banking and loans, labour relations, trademarks and patents, technology importation and licensing, accountancy practices, arbitration and bankruptcy.

4 OTHER MATTERS THAT WILL BE ON THE INVESTOR'S MIND

What is striking about both the Guidelines and representative Foreign Investment Codes is the extent to which they ignore so many of the conditions that most strongly influence direct foreign investors in arriving at their investment decisions.[3]

What long-term foreign investors are primarily interested in are the prospects of making profits commensurate with the investment risk, the ability to remit those profits after payment of reasonable tax, and the long-term security of their investments. The remainder of this section is devoted to listing conditions more vital to these concerns in the mind of the investor than many of the legal instruments and considerations that are listed in the Guidelines and in a characteristic Foreign Investment Code.

1. The country's track record in dealing with earlier investors. Just as a good track record lowers the supply price of capital in terms of the rate of return that will be looked for, so a bad track record inevitably puts the price up, however strong the protestations of reform from the current government.
2. How the domestic private sector is treated. This will be the first enquiry a potential foreign investor will make. The welcome extended to the foreign investor will seem insincere if the domestic private sector is repressed and discriminated against.
3. Exchange rate policy. An over-valued exchange rate will be regarded as a form of additional tax by any investor producing for export, while those producing for the domestic market will suspect that the resulting shortages will mean that imported materials will be difficult to obtain and dividends even more difficult to remit. Investors prefer to see not only an exchange rate that is realistic at the time of their investment, but one that will automatically be adjusted to keep it competitive.
4. An appropriate legal framework for business. This implies a law of contract and a law of bankruptcy and evidence that local courts do not discriminate against foreigners.
5. Management of inflation. Rapid inflation adds to costs and is usually evidence of a government's inability to match its own revenues and expenditures. It has the impact of an additional tax upon individuals, especially those with savings. It also has the technical effect of devaluing the capital allowances of businesses, artificially increasing their profits, and thus indirectly increasing the real rate of taxation.
6. Adequate personal security. A high domestic crime rate not only puts up the cost of doing

[3] When in October 1992 North Korea published its first 22-clause foreign investment law, Reuters reported the reaction of Japanese business to be 'We need stable politics, good subcontractors and labour force, and trustworthiness to do business with other countries. North Korea is lacking in such factors'. 'A sudden declaration of love is a nuisance'.

business, it may also have the effect of influencing the quality of businessmen that any intending investor is able to employ.

7 Educational and health facilities. The quality of these, whether provided by the host country's public or private sector, has an important influence on managements' decisions concerning business location.

8 Reliable power supply. Few other factors can disrupt production, make it difficult to meet delivery commitments, raise costs and cut into profits so severely as frequent and unanticipated disruptions to the delivery of power.

9 Other infrastructure. Similar concerns will be shown regarding the reliability and cost of rail and harbour facilities, water supply, local transportation for the workforce and, in particular, telecommunications.

10 The quality of the labour force. Productivity is perceived to depend not only on the industriousness and adaptability of local workers but also upon the reputation for being reasonable (or otherwise) of the local trade unions.

11 Labour ordinances. These act as a deterrent when they effectively give the Minister power to determine who should be employed and upon what terms and make dismissals subject to government approval. Those which lay down minimum standards and define the rights of trade unions are usually accepted providing their provisions are applied equally to foreign investors and domestic producers.

12 The reliability of domestic suppliers and subcontractors. When the foreign investor is expected to source his inputs from domestic producers, particularly if they are parastatals and monopoly suppliers, it is vital that those producers should be able to supply promptly, competitively, and to the required quality.

13 State marketing organizations (SMOs). A legal requirement to sell final output to or through an SMO will often act as a deterrent. Many SMOs have a poor reputation for efficiency, incorruptibility and prompt payment. In addition, this requirement makes brand name establishment more difficult and removes from the investor the commercial rewards that might be expected from achieving a higher quality of product than his co-producers.

14 Price controls. The right to impose price controls gives to the government rather than to the market the power to determine an enterprise's profitability or losses. A prime example of this is the sugar industry where, especially when an election is imminent, governments have a strong incentive to raise the price the factory is required to pay to the cane grower while keeping down the price of refined sugar that can be charged to the consumer. Where price controls are recognized as being necessary, the investor will look for a formula that is applied automatically, rather than be put in a position where he is required to make a case-by-case submission to some government authority.

15 Arbitrary decisions. These are anathema to business confidence and make investment planning very difficult, whether the arbitrariness arises at top government level or in a junior district official. The problem here is that the authority to give orders has long been one of the privileges of officials in one-party states. It is a surrender of authority (i.e. to the rule of law, to the terms of a contract, or simply to the market) that is not always readily made.

16 Petty corruption cuts both ways. On the one hand it may be seen as part of the local culture, inevitable where public sector salaries are so low, and something which facilitates the transaction of business. On the other hand, a widescale reputation for corruption will actually kill off the prospects of certain businesses — a good example would be certain countries' meat exports which remain unacceptable in the USA, the EC and Japan because everybody knows that a certificate of hygiene can be purchased from some public official whatever the state of the local abattoir.

17 Controlled interest rates. These almost always imply rates that are held by government below the level that the market would determine — usually to reduce the cost of government's own borrowings. For those who are able to take advantage of them, controlled interest rates might appear to act as an incentive to investment. In practice they almost always lead to a rationing of credit, an inefficient and bifurcated market, and, for the foreign investor, severely limited access to local credit at the controlled rate.

18 A unitary or mono-banking system. In no other sector is suitably regulated competition more important for the foreign investor (and indeed for the domestic investor as well) than in the provision of financial services. A monopoly commercial banking service, which would inevitably be controlled by government, gives bank officials unrestrained power, provides no incentive towards a modern, efficient service, and offers a bank the temptation (which is seldom resisted) to sit upon their customers' money for long periods earning interest for the bank itself, even in such simple matters as making international money transfers.

19 Fair access to the domestic money market. Investors will be concerned to see that in seeking funds the private sector is given a fair opportunity to compete. This can be prevented (and often is) by regulations requiring that pension funds, insurance companies, mutual funds, unit trusts, etc. hold a high proportion of their funds in government stock, thus limiting their discretion to invest in equities. It can also be frustrated by governments maintaining the interest rate on Treasury bills so high that investors are bound to hold them rather than equities.

20 A lively, but adequately regulated local stock exchange. A foreign investor may reasonably, in due course, wish to float a portion of his company. He will look for an exchange that is neither over- nor under-regulated. It was well said of the Bombay Exchange that some of its worst abuses flourished because the operations of the exchange were over-regulated and under-supervised.

21 Protective tariffs which are not excessive. High tariffs might initially seem to offer comfort to the intending investor, especially if part of his output is to be sold on the domestic market. But, in the longer term, they embody two dangers: first, that his domestic suppliers may supply inputs (equally protected) that are of low quality and high cost; second, that an eventual dismantling of the protective apparatus as part of IMF/Bank conditionality may leave his own project unprepared for foreign competition.

22 Reasonable rate of personal income tax. Most companies making a substantial foreign investment in a new project will want to see it managed, at least in its early years, by someone on their own pensionable pay-roll. Such employees, mainly expatriate, will be on a salary several times higher than the median salary in the host country, especially if special allowances are treated as part of taxable income. Because of the discrepancy in general income levels as well as the tendency of LDCs to have more sharply progressive tax rates with higher maximum rates, the employee may well find himself or herself assessed at twice the rate that would have applied on an equivalent income in his or her own domicile. To compensate for this, the project will have to increase senior expatriate salaries still further, a major proportion of which will then pass straight through to the government in personal income tax. This reduces the viability of the project, and leads to prêssure by all foreign investors to have the salaries of serving expatriate employees recognized as tax exempt. Such exemptions are in principle undesirable; but they are an inevitable consequence of high marginal rates on personal incomes.

5 GOVERNANCE AND THE WORLD ECONOMY

The Guidelines have a limited aim, restricting themselves to the consideration of what legal instruments a government should introduce if it wishes to create an economic environment encouraging to foreign direct investment. As we have seen, these cover only a small part of the spectrum of considerations that will determine the foreign investor's decision.

Commentators from developing countries are certain to be struck by the pronounced asymmetry in the Development Committee's approach. While codifying part of what may be said to constitute LDC good governance towards the foreign investor, the Development Committee has steered clear of discussion of some far more important determinants of the level of beneficial foreign investment in developing countries — namely, conditions in the world economy, and what good governance exercised by the governments of the OCED countries could do to bring about an improvement in the fair conduct of international economic relations. Any such discussion would have to deal, *inter alia*, with the following items:

- practices amongst OECD governments that have the effect of lowering the price of LDC commodity exports;
- world interest rates that push up the required rate of return on LDC projects to a level that severely reduces attractive investment opportunities;
- an external debt overhang (with an increasing proportion of it being owed to the International Financial Institutions) that will clearly impede the ability of many of the poorer LDCs to allow the free remittability of interest or profits;
- increased protectionism against LDC manufacturers;
- the dumping of farm surpluses grown under subsidized price regimes onto international markets in a manner that damages the prospects (and often destroys the profitability) of tropical producers;
- the propagation of a new public morality which insists that it is in the general interest that all factors of production should become internationally mobile, except one — unskilled labour.