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## **How to attract FDI and maximize its benefits: part II**

### **Effects of FDI Inflows in Services Sectors**

The studies mentioned above focus on FDI inflows into manufacturing sectors. However, FDI inflows into services industries may be beneficial to the host country as well. Foreign investors may improve and expand the set of available producer services and introduce international best practices. By doing so, they may also induce domestic competitors to make similar improvements. Given the limited scope for using cross-border trade to substitute for domestically produced services inputs, the performance of downstream sectors may be tied more directly to the quality and availability of services supplied by providers operating domestically than is the case for physical intermediate inputs. Furthermore, the availability of high quality efficiently supplied services, especially backbone services (transport, telecommunications, ports management) is critical to participation in a new division of labor driven by global production networks based on production fragmentation. This is so, simply because interaction among “production blocs” of border-spanning production networks is particularly vulnerable to delays and disruptions between individual stages of the supply chain due to weaknesses in service links.

A greater choice of services providers may in turn affect the performance of manufacturing sectors in three ways. First, entry of internationally successful players into services industries may lead to higher quality and reliability of services. For instance, international phone communications or electricity provision may become more reliable due to new investments in infrastructure or credit decisions may be made faster as competition among banks increases. This will in turn limit disruptions to production and decrease the operating costs in downstream manufacturing sectors.

Second, new services may become available as a result of foreign entry. Examples include new financial instruments, multi-modal transport services or digital value-added services in telecommunications. Availability of such services may allow manufacturers to introduce productivity-enhancing changes to their operations, such as receiving production orders on line or setting up on-line bidding systems for suppliers.

Third, services’ liberalization may lead to a wider availability of services that were previously restricted to certain groups of users, such as expanding internet coverage into rural areas or the availability of business services to smaller firms. The improved access may in turn enhance competitiveness of smaller or remotely located domestic enterprises.

The results of a firm survey conducted by the World Bank in the Czech Republic in 2004 show that Czech firms perceive the effects of services liberalization as positive. A vast majority of respondents reported that liberalization of services industries contributed to improvements in quality, range and availability of services inputs in their country. The positive

perceptions ranged from 55% of respondents asked about the quality of accounting and auditing services to 82% for telecommunications. With regards to the variety of products offered, the positive views of liberalization varied between 56% of respondents evaluating accounting and auditing services to 87% of respondents asked about telecommunications. The corresponding figures for the effect on services availability ranged from 47% in accounting and auditing to almost 80% in telecommunications.

To formally examine the link between services liberalization and the performance of services users, a recent study [Arnold, Javorcik and Mattoo, 2006] relates total factor productivity of manufacturing firms to the state of liberalization in upstream services sectors. The study uses firm-level panel data from the Czech Republic for 1998–2003. The reliance of each manufacturing sector on each services sector, assessed on the basis of the national input-output matrix, is used as a weight to create manufacturing sectors' exposure to services reform. The study uses several proxies to capture the extent of liberalization in services sectors.

The first measure is a set of policy reform indices published by the European Bank for Reconstruction and Development. Time-varying indices are available for banking, telecommunications, electric power, railway transport, road transport and water distribution. The other measures capture a particular aspect of liberalization: (i) the extent to which foreign investors have entered Czech services industries, proxied by the share of an industry's output produced by foreign-owned companies; (ii) the progress of privatization in services industries, proxied by share of an industry's output produced by private companies; (iii) the level of competition in services industries, measured by the market share of the four largest providers. The empirical specification also includes a comprehensive set of controls for other channels through which increased openness may affect firm performance.

The results demonstrate a positive correlation between liberalization in services sectors and the productivity of manufacturing firms relying on services inputs. A positive and statistically significant relationship is found for the policy reform index, the presence of foreign providers in services sectors and the extent of privatization in services industries. The relationship between the presence of foreign providers in services sectors and the performance of manufacturing firms relying on services inputs is the most robust. These findings are consistent with services sector liberalization, as manifested by FDI inflows into the sector, being associated with improved availability, range and quality of services, which in turn contribute to improved performance of manufacturing firms using services as inputs.

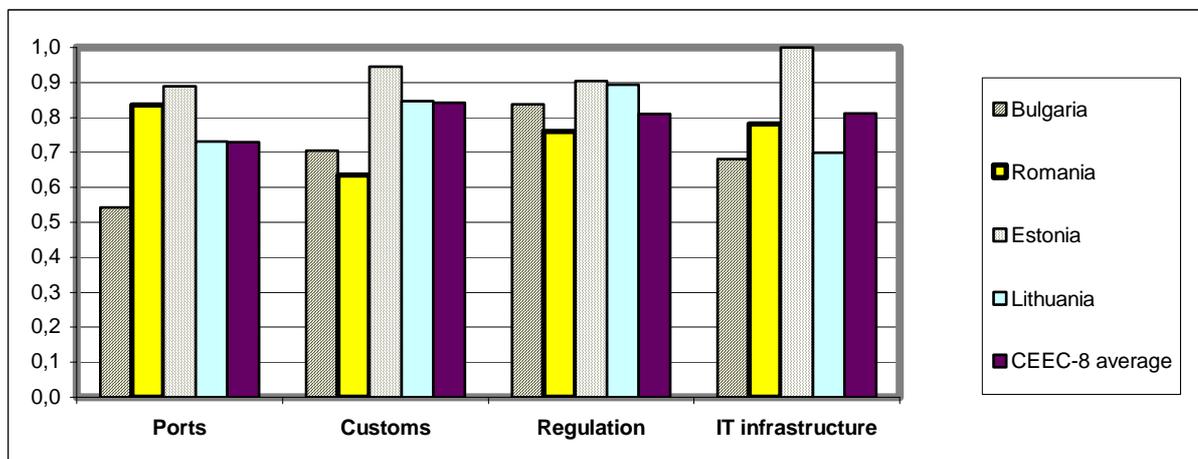
Taken together, the results of these three studies highlight the potential of FDI for enhancing competitiveness of host economies through productivity improvements and technology transfer.

### **How Can New Europe Attract More FDI Inflows?**

FDI inflows are commonly classified into those driven by search for natural resources, search for markets and search for cost savings. From the perspective of New Europe economies, natural-resource seeking FDI is not particularly interesting because of limited natural resource endowments in most of the New Europe economies and the fact that little can be done to change it. Hence, this section will focus on the other two types of FDI.

Turning to market-seeking FDI, almost all careful empirical studies have found a positive relationship between a host country's market size and the volume of FDI inflows. The importance of market size puts smaller economies at a disadvantage relative to larger countries. However, this disadvantage can be remedied through participation in regional trade agreements as demonstrated by recent research. For instance, Head and Mayer [2004] find a positive correlation between entry of Japanese firms into the European Union and the mar-

ket potential indicators, which aggregate demand from multiple EU regions (adjusting it for the distance). Given that New Europe economies are part of the EU, they have already benefited from the access to the large market of the EU and can count on doing so in the future.



However, the benefits of being part of the EU can be reduced or enhanced by the quality of the transport infrastructure and other aspects of trade facilitation such as port efficiency, customs environment, regulatory environment, and IT (Information Technology) infrastructure.<sup>1</sup> New Europe economies have a long way to catch up with the EU-15 in this respect. Figure 4 presents the values of trade facilitation benchmarks in terms of performance of the EU-15 (1.00) for CEEC-8 (new Central European EU members), two best performers among them (Latvia and Lithuania) and two EU candidate countries—Bulgaria and Romania. Significantly lower quality of services explains poor performance of Bulgaria and Romania in attracting FDI in supply chains of large multinational corporations, as demonstrated in their limited participation in global producer-driven networks [see, Javorcik and Kaminski, 2006].

The importance of transport infrastructure and trade facilitation as a determinant of FDI is confirmed in a recent econometric analysis by Amiti and Javorcik [2005]. The authors show that the proximity to ports, size of port facilities and the availability of railways affect foreign entry into Chinese provinces. They also demonstrate that entry of foreign firms is driven by access to the market in the host province and to a much lesser extent by the proximity to markets in other provinces. This latter finding can be explained by the poor quality of distribution infrastructure and the informal barriers to inter-provincial trade in China.

FDI motivated by cost savings is sensitive to differentials in labor costs. However, what matters is unit labor costs, that is wages adjusted for productivity rather than wages alone. Thus, low cost labor force with low quality human capital may not always be appealing to foreign investors. New Europe enjoys a significant cost advantage relative to the EU countries particularly with respect to skilled labor, which combined with growing skill endow-

<sup>1</sup> Port efficiency refers to the quality of infrastructure of maritime ports and airports; customs environment to direct customs costs as well as administrative transparency of customs and border crossings; regulatory environment to the country's approach to regulations and their quality; and IT infrastructure to the extent to which an economy has the necessary domestic infrastructure (such as telecommunications, financial intermediaries, and logistics firms) and is using networked information to improve efficiency and to transform activities to enhance economic activity.

ment makes them well positioned to attract efficiency seeking FDI in medium to high technology sectors.

As illustrated in Table 1 the proportion of economically active population with secondary education is actually higher in New Europe economies than in the EU-15. Together with relatively low values of the indicators of labor market participation for most New Europe economies, this suggests a significant potential for the expansion of skilled labor intensive production. Indeed, as Marin [2004] shows, Austrian and German corporations tend to outsource their skill intensive activities to Eastern Europe. This does not apply only to Austrian and German corporations but to MNCs coming from other countries as well [Javorcik and Kaminski, 2006].

By the same token, New Europe economies are not competitive *vis-à-vis* Asian countries in low technology sectors, with the exception of high-end time-sensitive products. Just like is the case with market seeking FDI, the cost advantage of the New Europe economies may be reduced by high costs of doing business associated with worse governance or excessive regulation. It can be enhanced, however, by increases in skill endowment through investments in education and R&D.

To keep and enhance their advantage as an attractive FDI location, New Europe economies are likely to benefit from a four-pronged strategy. First, as argued above, they should catch up with old EU-15 in terms of trade facilitation. Second, New Europe economies should aim to catch up with old members of the EU in terms of governance and transparency. Transition countries with better governance have been more successful in attracting FDI inflows. This is not surprising, given the fact that lack of transparency and high incidence of corruption act as a tax on foreign investors and deter them from investing [see, Wei 2000, Smarzynska and Wei 2000).

While differences among New Europe economies in quality of governance persist, they have been gradually converging upwards in terms of establishing competition-supporting institutions, which has significant implications for the choice of strategy to attract FDI, as discussed below. The prospect of EU accession contributed to the change in domestic policies as well as acceleration in structural, second generation reforms in the second half of the 1990s. Countries excluded from the first group of invitees to launch accession negotiations in 1996, most notably Slovakia, but also Bulgaria and Romania later revised their privatization programs and returned to the reform path. Hungary's opening of so-called strategic sectors, banking and telecommunications, in 1995 to foreign investments prompted similar moves in other New Europe economies. In consequence, the variation in progress in transition significantly declined, as captured by the values of the coefficient of variation (ratio of standard deviation to average) of EBRD structural reform indicators in 1989-2004 (for an explanation of indicators, see note to Figure 5).

The combination of these developments has led to an increase in FDI, with the achieved progress in economic reforms as a major variable explaining the variation in flows to New Europe economies. While in 1993-95 the value of correlation coefficient between cumulative inflows of FDI per capita and the progress in economic transition (see note to Figure 5) was 60 percent, it rose to 82 percent for 1993-2000 and 86 percent in 1993-2003. Considering differences in GDP *per capita* and the size of economies in terms of population, this is a surprisingly strong positive correlation between reforms and FDI inflows.

Its lower value for 1993-95 can be explained by relatively low FDI inflows to three initial radical reformers: Poland due to the unresolved servicing of its private foreign debt, the Czech Republic and Slovakia due to the choice of the mode of large scale privatization that deliberately excluded foreign investors. Poland's agreement with the London Club, the change of government in Slovakia in 1998 and the change of policies towards foreign inves-

tors in the Czech Republic in response to negative GDP growth in 1997-99, all appear to have contributed to even larger correspondence between FDI inflows and steps forward in transitioning to a modern market economy. Furthermore, Bulgaria and Romania, after almost a decade of aborted reforms, have undertaken serious effort prior and after the EU decision to begin accession negotiations with these countries in December 1999.

As a consequence, the positive link between progress in economic reforms and FDI flows has become even stronger, corroborating findings of empirical research showing that liberal reforms provide a more powerful explanation of variation in FDI flows to former centrally-planned economies than to other developing countries,<sup>2</sup> although there are many other factors involved as the early success of Hungary illustrates. With New Europe economies gradually converging in terms of closing the institutional gap *vis-à-vis* highly developed market economies, the challenge they face in competing for FDI inflows is to go deeper to make themselves attractive to foreign investors. Research suggests that the area promising to be the most effective to achieve this goal is liberalization of labor markets [Javorcik and Spatareanu, 2005b].

Hence, the third element of the strategy should include allowing greater flexibility in labor regulations relative to the conditions prevailing in the old members of the EU. As illustrated in Figure 6, there is a lot of variation in this respect both within the old and the new Europe. A rigid labor market, which limits the ability of foreign affiliates to adjust the size of the labor force, is likely to be less attractive to foreign investors than a location with a similar level of wages and greater labor market flexibility. This is the conclusion of recent work by Javorcik and Spatareanu [2005b] who examine labor market flexibility affects foreign direct investment (FDI) flows across 19 Western and Eastern European countries. Their analysis uses firm level data on new investments undertaken during 1998-2001. The study employs a variety of proxies for labor market regulations reflecting the flexibility of individual and collective dismissals, the length of the notice period and the required severance payment along with controls for business climate characteristics. The results suggest that greater flexibility in the host country's labor market in absolute terms or relative to that in the investor's home country is associated with larger FDI inflows.

The final component of the strategy should focus on FDI promotion efforts in the form of image building, FDI generation, investor servicing and policy advocacy rather than financial and tax incentives favoring foreign investors over domestic firms. The latter recommendation is due to EU regulations restricting the use of incentives aimed solely at foreign investors and to the fact that the jury is still out on the effects of taxation and fiscal incentives on FDI flows [Blonigen, 2005; and Desai *et al.*, 2004]. Subsidizing foreign investment is often justified with knowledge spillovers from FDI that are expected to benefit local producers. As this externality is not captured by foreign investors, they will tend to underinvest which calls for government intervention. However, as we have seen from the literature review above, the scope of such spillovers is limited to inter-industry effects so it is unclear whether the externality is large enough to justify the subsidies.

## **FDI promotion**

Most countries use investment promotion agencies (IPAs) as a key part of their strategy to attract inflows of foreign direct investment. There exist more than 160 national and over 250 sub-national IPAs [UNCTAD, 2001]. Creation of IPAs is a relatively new phenomenon as only a handful of these agencies existed twenty years ago [Morisset, 2003]. The theoretic-

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<sup>2</sup> See, for instance, Claessens *et al.* [1998], Garibaldi *et al.* [2002], Broadman *et al.* [2004].

cal justification for the public support for investment promotion is based on a market failure. Potential foreign investors must incur a cost in order to gather information about the potential returns available in alternative investment locations. This cost may be increased by the fact that local firms and other foreign investors operating in these locations may actually have an incentive to restrict information flows in order to prevent the entry of potential competitors. As argued by Greenwald and Stiglitz [1986], markets for information are fundamentally different from other markets and in the presence of imperfect information they may not produce Pareto efficient outcomes. By disseminating information about potential investment opportunities in its country, an IPA can enhance the availability of information to potential foreign investors and facilitate more efficient capital allocation.

Activities of IPAs tend to focus on four areas:

- national image building,
- investment generation,
- facilitation services for potential investors, and
- policy advocacy (Wells and Wint 1990).

By means of promotional campaigns designed to build a positive image of their country as an investment destination and by linking foreign investors with potential joint venture partners or suppliers, IPAs serve as a conduit of information and contribute to diminishing the market failure described above. IPAs also lower the entry costs for potential foreign investors by assisting investors in complying with administrative procedures. Finally, IPAs may contribute to increasing the profitability of foreign investment projects in their country by advocating improvements in the business climate or preferential treatment for foreign investors.

In 2002 the average budget of an IPA was US\$ 585,500 in a low income country, US\$ 1,237,000 in a middle income economy and US\$ 9,382,100 in a high income country. Seventy-six percent of IPA budgets came from governments. A typical IPA in a developing or a transition country was about 10 years old and was a public body, constituting part of a ministry or an autonomous agency. The median agency employed ten professional staff. It typically concentrated most financial resources on image building (38% of spending), followed by investment generation (29%), investor services (25%) and policy advocacy (8%) [Morisset and Andrews-Johnson, 2004].

Recent empirical studies have documented a positive correlation between investment promotion activities and FDI inflows. This was the conclusion of the seminar work by Wells and Wint [2000] based on case studies, structured interviews with individuals involved in investment promotion and an econometric analysis of 50 industrial and developing countries. This result was confirmed by subsequent work of Morisset [2003] who employed the results of a survey conducted by the Foreign Investment Advisory Services (FIAS) among 75 IPAs worldwide. The most rigorous study to date by Charlton and Davis [2004] focused on the question whether IPAs had been more successful in attracting FDI inflows into industries they explicitly target. The study was based on industry-level data on FDI inflows into 28 OECD countries during the 1980-2000 period combined with information on targeted industries collected through a survey of IPAs. Using the difference-in-differences specification, the authors found that targeting of an industry by the IPA increases the FDI into that industry by 60 percent.

## Conclusions

This paper focused on two questions: why attracting FDI is worthwhile and how to go about it. Its major findings can be summarized as follows: First, receiving FDI has a positive direct effect on the performance of the previously domestically owned plants. This suggests

that FDI inflows are associated with transfer of technology and know-how and thus may present potential for productivity spillovers to other firms in the host country.

Second, presence of multinationals has two opposing effects on domestic firms operating in the same sector. On the one hand, it increases competition in the sector, which in the short and medium run may lead to local firms losing part of their market share and thus facing an increase in their average cost. In the long run, the increased competitive pressures may force less productive local firms to exit, thus raising the average productivity of the industry. On the other hand, foreign presence may lead to knowledge spillovers through demonstration effects and movement of labor, thus enhancing the performance of local enterprises. The relative magnitudes of these effects depend on the circumstances specific to host countries such as the initial level of competition, quality of the business climate and skill endowment.

Third, positive externalities associated with FDI are not limited to the industry of operation. Presence of multinationals in downstream sectors tends to increase the productivity of local producers in the industries supplying intermediate inputs. FDI inflows into services sectors and the resulting increase in the quality, availability and range of services may enhance the productivity of manufacturing firms relying on services inputs.

Fourth, having reached macroeconomic stability and increased their market size through accession to the European Union, New Europe's economies have become an attractive location for FDI inflows. However, the benefits of being part of the EU can be reduced or enhanced by the quality of the transport infrastructure and other aspects of trade facilitation such as port efficiency, customs environment, regulatory environment and IT infrastructure. Similarly, further increases in FDI inflows can be achieved through improvements in governance and a regulatory environment, an area where New Europe economies still lag behind the EU.

Fifth, to keep its attractiveness to efficiency seeking FDI, New Europe economies should aim to provide a more business-friendly environment than that prevailing in the EU, particularly with respect to labor market flexibility, and should continue to build up the skill level of their workforce.

Finally, efforts to attract FDI inflows may be aided by well orchestrated FDI promotion efforts, focusing on building a positive image of the country, efficient servicing of the existing investors, pro-active investment generation and policy advocacy. Offering financial and fiscal incentives exclusively to foreign investors is neither acceptable under the EU regulations nor desirable as there is no convincing evidence that the benefits of doing so would exceed the costs.

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**Table 1 Endowments in New Europe Economies in Comparative Perspective:  
Selected Indicators in 2003**

	Land, km <sup>2</sup> per capita	Land use, arable land (% of land area), 2001	Economically active population with secondary education (%)	Economically active population (% of total population)	Labor market participation <sup>a/</sup>	Electricity production (kwh per capita), 2002	Electricity consumption (kwh per capita), 2002	Natural resources Index, 2004 <sup>b/</sup>
Bulgaria	0.014	40.0	<b>55.3</b>	42.0	49.2	5,424	3,056	0
Czech Republic	0.008	39.8	<b>79.2</b>	50.0	59.3	7,484	3,882	0
Estonia	0.031	16.0	58.1	48.9	58.7	6,278	3,099	0
Hungary	0.009	<b>50.1</b>	65.7	41.2	49.8	3,559	<b>2,074</b>	0
Latvia	0.027	29.7	65.8	48.5	57.5	<b>1,700</b>	1,929	0
Lithuania	0.019	45.2	63.2	47.4	58.2	5,108	2,498	0
Poland	0.008	45.9	70.9	44.4	54.7	3,770	1,595	1
Slovak Republic	0.009	..	79.1	48.7	60.2	6,028	4,222	0
Slovenia	0.010	<b>8.6</b>	63.2	49.0	56.5	<b>7,480</b>	<b>5,998</b>	0
Romania	0.010	40.8	60.2	44.4	54.7	2,463	4,979	1
EU15 <sup>c/</sup>	0.014	24.3 /1	44.4 /2	47.1	56.7	7,073	6,086	

Notes:

All data are for 2003, unless otherwise specified; 1/ Excluding Luxembourg; 2/ Excludes France (secondary education data not available); 2002 data used for the Netherlands.

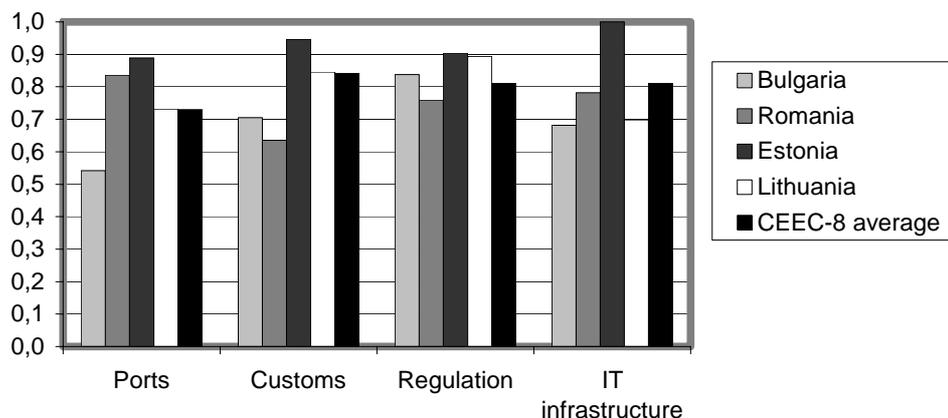
<sup>a/</sup> ILO Methodology: Economically active population divided by total population over 15.

<sup>b/</sup> Falcetti et al., EBRD, 2004. Countries are rated from 0 to 2, 2 being the highest.

<sup>c/</sup> Simple average.

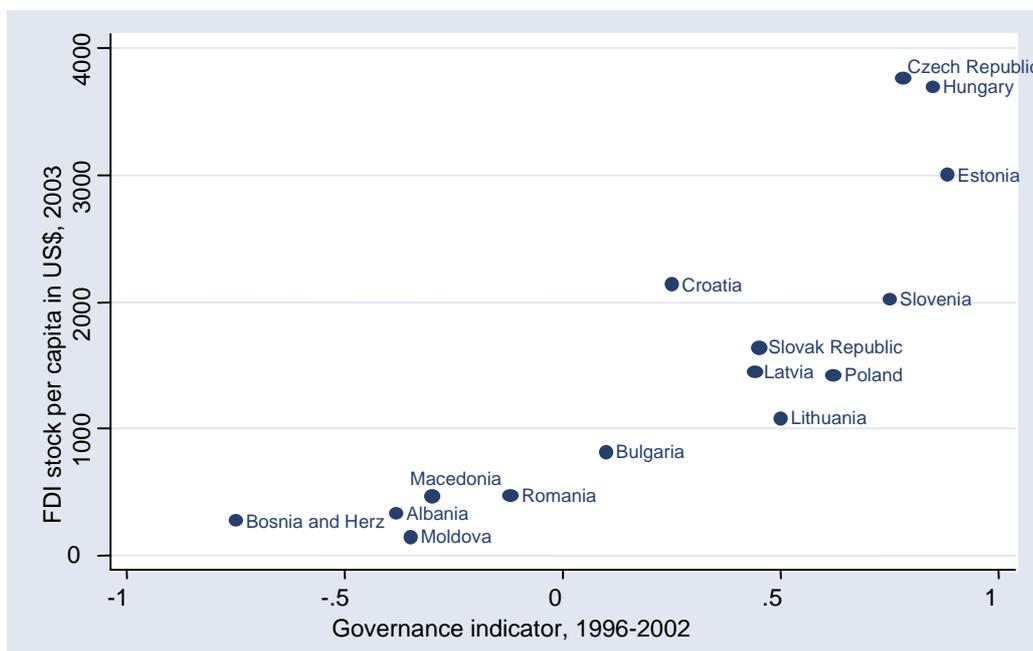
Sources: Eurostat, WDI 2004.

**Figure 4 Trade Facilitation Benchmarks for Selected Countries  
Against the EU-15 Average Level**



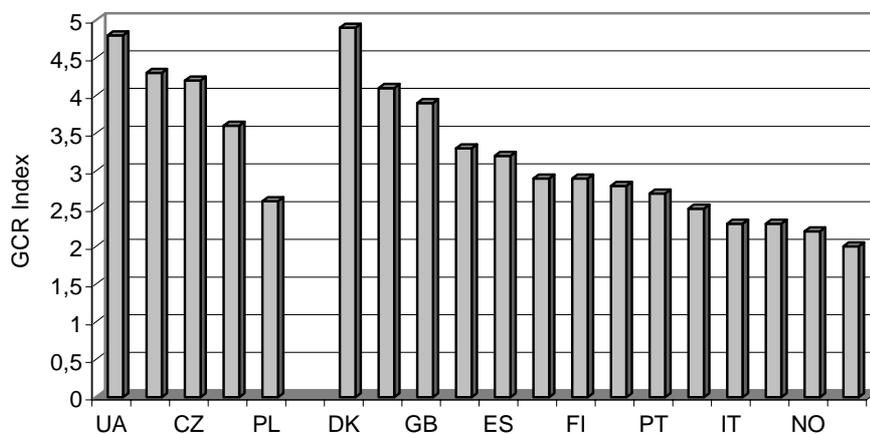
Source: see, Kaminski [2006].

**Figure 5** Quality of Governance Matters for FDI Inflows



Source: IMF's International Financial Statistics for FDI data.

**Figure 6** Global Competitiveness Report Index of Labor Market Flexibility



Notes:

Index of Flexibility of Hiring and Firing Practices from the *Global Competitiveness Report 2001-2002* (published jointly by the Geneva-based World Economic Forum and the Center for International Development at Harvard University. The index quantifies the average response to the survey question: "Is hiring and firing of workers impeded by regulations or flexibly determined by employers?" It takes on the value of 7 for a very flexible labor market and 1 in the case of the most rigid ones. It is based on the views of "business practitioners" in each country, hence it captures both laws on the books and their enforcement.