The Rationale and Classification
of National Investment Promotion Policies

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I. ANALYSIS

An analysis of national investment promotion policies starts logically with a statement of the objectives to be served. Such objectives are necessarily political in nature in that there is no objective economic function specifying what objectives a national policy should seek. Obviously, these politically-derived objectives should be internally consistent to the extent possible, and the economic objectives, the least costly ways of fulfilling them. In the process, one should be aware of the trade-offs between economic costs and benefits and political costs and benefits.

1. NATIONAL POLICY OBJECTIVES

Although this analysis does not purport to be a complete exposition of the paths to national development, at least some of a nation's objectives relate to such choices as:

- Degree of international economic integration, from autarky to complete regional or international integration.

- Wealth and income distribution among the total population, between geographical regions, between rural and urban areas, among various ethnic-religious groups, between property owners and workers.

- Time horizon of consumption, that is, the trade-off between present and future consumption (measured by the propensity to consume incremental income).

- Rate of increase in per-capita production, from high (10% or more) to low (2% or less).

- Degree of participation in decision-making in respect to enterprise management, from authoritarian to self-management.

- Degree of participation in decision-making in respect to national allocation of resources, from authoritarian or elitist to broadly democratic.
- Degree of national specialization in production.

- Reward system, which may be based on the promise of immediate consumption by the individual roughly equal to the market-derived value of his production, or "from each according to his abilities, to each according to his needs" (the welfare system), or something in between.

- Degree of dispersion of literacy, basic education, and skills.

- Degree of environmental protection, from unrestrained environmental exploitation to maintaining environmental integrity.

- Degree of consumer protection, from none to a high level of protection via regulation and producer's liability.

Obviously, not all choices are consistent. If a nation opts for a high degree of autarky, it cannot logically also opt for a high degree of specialization in production, or for a high rate of increase in per-capita production. If it commits itself to a high growth rate, it cannot expect to maintain a high propensity to consume incremental income. Nor is a market-derived reward system consistent with equality of wealth or income distribution, nor with public or social ownership. Measures to force more even income and wealth distribution among regions or various groups may not be consistent with high economic growth rates, at least in the short or medium-term run. Heavy investment in literacy, education and high-level skill generation may reduce the capacity of a society to sustain a high rate of economic growth in the shorter run. Some present consumption must be sacrificed by a society in order to invest the wherewithal to produce future consumption, unless it can attract foreign savings. But such attraction says something about the degree of international economic integration a nation is willing to tolerate.
Under many circumstances, maximum economic growth in an aggregate national sense is probably consistent with (1) a relatively high level of international economic integration, (2) some degree of restraint on inequality of income and wealth distribution generally, (3) protection of private ownership and control of productive assets (but subject to some restraint in the interests of income distribution) of all but those activities whose social benefits are too diverse or too delayed in time to internalize in the form of financial profit, (4) a long consumption time horizon (but not too long as to destroy incentive), (5) a relatively high degree of participation in enterprise and national decision-making (but to some degree dependent on the level of development of the education and information systems) and of the degree of political socialization, (6) specialization in production, (7) a reward system somewhere between the purely market-driven and pure welfare types, (8) a low level of environmental and consumer protection. That is, one should be conscious that virtually all policy choices may introduce a "cost" in the sense of some loss of technical efficiency and, hence, of economic growth. This is not to say that any of these policy choices are wrong, only that they may introduce economic costs.

On the other hand, economic objectives -- such as maximum growth -- introduce political costs by ruling out a number of possible options, some of which may be both politically compelling and ideologically desirable.

It should be borne in mind by national policy-makers that the effectiveness of any foreign investment and technology promotion/control regime rests on a number of factors. These are:

1 - The intensity of the political will of the decision-making authorities, which possibly relates to the degree of consensus and the continuity of that consensus (a measure of which may be the clarity with which national objectives are stated).
2 - The technical feasibility of the laws and regulations promulgated, that is, their consistency and enforceability.

3 - The adequacy of the resources (financial and human) committed to implement these laws and regulations.

4 - The adequacy of the authority vested in the bureaucracy charged with the implementation of the relevant laws and regulations.

5 - The consistency of the political ideology as between policy-makers and the relevant bureaucracy, which possibly depends upon similarity in terms of economic-social backgrounds, sense of security or threat, and reward system.

6 - The integrity of the relevant bureaucracy, which is possibly related to its pay level, job security, perceived political stability, existence of a free press, and effectiveness of law enforcement.

7 - An effective feedback system whereby policy-makers are made constantly aware of the effectiveness of the relevant laws and regulations.

It is very likely that control of all foreign firms in all sectors in all activities is impossible short of a complete prohibition of all foreign business entry (for example, the People's Republic of China up to a few years ago). It is clearly important to evaluate the impact of the relevant laws and regulations on both foreign and domestic firms and on flows of direct foreign investment and contracts between unrelated parties, thereby ascertaining any unintended differences in impact which may be arising. Possibly the easiest type of promotion or control to make effective is either industry or function-specific (for example, sale of securities) without differentiation as between foreign and domestic firms.

2. THE NATURE OF IMPLEMENTING DEVICES

We now turn to a discussion of some of the problems embedded in the administrative devices used by government to push or pull resources, foreign and domestic, in the directions dictated by policy objectives.

It must be recognized that, by definition, the introduction of an incentive or disincentive is an intervention in the market and is likely to introduce distortions. If the distortions are those intended, the
intervention serves the objectives desired by the policy-makers. Problems arise when the distortions generated are not those intended. Of course, the market may already be distorted, and the intervention is designed to improve the market. Antitrust legislation is of this nature.

In any event, a deliberate market distortion either awards a benefit (reduced cost) or imposes a penalty (increased cost) to enterprises satisfying certain conditions. In the first case, the national economy pays a subsidy; in the second, it extracts a tax. Essentially, then, we are talking of transfer payments between the private (market) sector and the public (government) sector.

The key question for the public policy-maker, in the case of a subsidy, is whether society (or the government) gains something equal to, or exceeding, the cost of the subsidy. The key question for the corporate decision-maker is whether the value of the subsidy is equal to, or exceeds, the added cost of satisfying the conditions for receiving the subsidy.

Incentives work through the following mechanisms: (1) by lowering factor costs, where the factors consist of land, raw materials, labor, capital, technology (including skilled manpower), energy, and entrepreneurial risk-carrying capability, (2) by raising product prices, or (3) by directly increasing after-tax profits. Disincentives work in the reverse direction, up to and including prohibitions on certain activities.

The devices used to trigger these mechanisms, as we shall see, are foreign exchange controls, restrictions, guaranties, credit terms, tax adjustments, market protection, and subsidies. Each device either creates an imperfection in the market or compensates for an existing imperfection, thereby stimulating or discouraging particular activity.
While the benefits of an incentive (or the penalties imposed by a disincentive) are the attainment of policy targets, there are always associated social or public costs. These costs may be measured by: (1) revenue lost by a reduction or waiver of taxes (income, sales, import, estate, payroll, property, transaction, etc.), or by providing concessionary interest rates on loans, (2) expenditures incurred by reason of grants or subsidies, (3) costs imposed on the economy by higher (or lower) product or factor prices, and (4) costs imposed on the economy by secondary or tertiary results from distortions of resource flows not intended by the policy-makers, such as the congestion of cities and ports.

Certain administrative devices, and problems inherent in them, warrant further comment, as likewise do some of the objectives which they purportedly serve.

3. SOME SPECIFIC POLICY OBJECTIVES

Among those singled out for discussion here are exports, employment, income and wealth distribution, local ownership and management, and technological development.

A. Exports. A sector receiving special attention in many countries is exports. A wide range of export incentives are found in the form of subsidized imported components (for example, the customs' drawback device), preferential access to raw materials, reduced or waived taxes on income derived from exports, free trade and export processing zones, price subsidies, outright grants, special credit and guarantee facilities, special treatment of foreign exchange earnings, and assistance in market development. The obvious purpose of such incentives is to stimulate exports by reducing their cost and thereby creating or expanding foreign demand for the nation's output. This increased demand may help achieve economies of scale in production, diversification of the domestic economy, alleviation of domestic recessions, and reduction of balance-of-payments deficits caused by imports and the servicing of foreign
debt and investment needed for economic growth (The greater a nation's propensity to use added income to purchase foreign-produced goods and services, the more severe is the problem.).

The central problem generated by export subsidies and/or import protection is that if these devices are anything other than temporary measures to permit a local industry to start up and achieve maturity, permanently high-cost industry is encouraged which may require continuing subsidy. A further consideration is that the demand for a nation's goods on foreign markets may be more a function of quality in design, delivery, promotion and service than of price.

B. Employment. Increased employment is brought about by expanding output if the increased output increases the demand for labor (which may not always be the case). Substitution of a more technically efficient process may increase output but reduce employment. A government can create pressures for increased employment by lowering the cost of labor to firms, or by providing free or low-cost training to upgrade labor skills. Among the incentives used to achieve this end are training schools and subsidized in-plant programs (as in Indonesia), employer tax reductions based on payroll (as in Malaysia), cash payments for hiring previously unemployed or unskilled labor (only example here is Ireland), or by liberalizing constraints on foreign ownership (as in the Philippines).

A common restriction is a provision that a certain minimum percentage of the workforce must be local nationals. The danger is that a government may enforce such restrictions even though adequately skilled manpower is not available. The results may be blocked investment or unduly high costs as the enterprise itself is forced to bear the costs of training. It should be noted that firms not offering training to their employees are in
a position to pirate skilled personnel away by offering higher wages, which they can afford as they are not incurring the training costs.

In general, society may gain if grants or tax reductions are given to industry so as to encourage maximum employment, so long as the value that is added by this labor is at least equal to the cost of subsidizing that labor. Of course, to the extent that various incentives and restrictions reduce the cost of capital, a business firm's propensity to add labor is reduced. Similarly, if social welfare programs push the cost of labor up, firms will seek to substitute capital for labor. While one might argue that, in the long run, society gains through the higher level of technical efficiency, the short run unemployment and welfare problem could become intolerable.

C. Income and Wealth Distribution. A number of countries, concerned with the uneven distribution of income and wealth, have offered various forms of incentives to induce companies to sell their stock publicly. Brazil, Malaysia, and Iran are examples. Sometimes the government buys the stock for resale to various categories of the public -- to employees (as in Iran) or to members of certain ethnic groups (as in Malaysia). Several problems are associated with such schemes. In the first place, if an employee owns shares in the company which employs him, he compounds his risk. Both his job and his capital become dependent upon the welfare of one firm. If such shares may be transferred to others so that one has the possibility of reducing risk through diversification, then some variety of public securities market is required. For such a market to work efficiently, effective commercial law must operate to protect the interests of minority shareholders. Also, the market must be large enough, and controls sufficiently sophisticated, to reduce the possibility of price manipulation by speculators.

Perhaps an effective measure in many circumstances to gain the same ends of income and wealth distribution and a greater sense of participation would be to initiate a system of profit-sharing (either by
enterprise or sector) and of participant management of some variety. The Yugoslav system seems the most successful on both counts and may warrant study by governments with wealth and authority distribution objectives. At least in the short run, it should be borne in mind that participant management possibly reduces technical efficiency. In the longer run, the reverse may be true.

Geographic distribution of income is encouraged by the dispersion of industry and employment opportunities. Ways to encourage such dispersion are the development of industrial estates, the offer of locational grants, differential tax rates favoring certain regions over others, providing infrastructure in specified depressed or backward areas, giving preferential or subsidized credit, permitting special locational allowances and write-offs against taxable income, making raw materials available on a preferential basis, or enforcing an outright ban against locating in designated impacted areas.

Although perhaps politically and socially desirable, what one is doing is to distort market conditions so as to create what could very likely be permanently inefficient industries. Presumably without the subsidies, these industries would not locate as they do. That is, these locations are not the lowest cost sites, for many enterprises enjoy lower costs when located near a dense market, large labor pool, or well developed infrastructure. There is a social-economic trade-off between the higher cost forced on dispersed enterprises and the social saving of providing employment without large-scale urbanization.

A government may reduce some of the costs of dispersion by locating dispersed industry on industrial estates where at least some of the economies of scale in the provision of infrastructure (communication, transportation, energy, water, waste disposal, etc.) can be realized. Hopefully, when such complexes reach a certain scale, they will prove efficient without further government support. That is, firms will then seek them out as the lowest cost sites.
Whatever their cost, decentralization incentives do tend to reduce geographical income disparities, as well as contain rural-urban migration by enlarging employment opportunities in rural areas. The social saving may be considerable in terms of the urban facilities which would otherwise be required.

An increasing list of countries is insisting upon restricting the expansion of production to those sites approved by the authorities. Possible criteria include: environmental pollution (air, water, noise, odor, danger), density of use of infrastructure systems (transportation, energy, water supply, waste disposal), population density, and alternative site use (housing, recreation, open space, farming, etc.). In some cases it is reported that a firm may spend as long as a year or more locating an acceptable site (an example is Indonesia). Difficulty in siting a plant can add substantially to the cost, or even block its construction altogether. Some governments maintain special offices to assist private firms in finding sites that are both commercially and socially acceptable.

D. Local Ownership and Management. Some incentives and dis-incentives discriminate between foreign-controlled and domestically-controlled enterprises by reserving certain sectors for domestic investors only, and others in which joint ventures are permitted (possibly ventures in which the foreign participant is held to a minority interest), or by simply imposing a legal limit on foreign equity participation.

Common to all countries is the reservation of certain sectors to local citizens or to domestic firms with some specified percentage of local ownership. Frequently, such sectors are judged to be either politically-sensitive (examples: tele-communications, domestic transportation, publishing, energy generation, mining), within the technical and financial capability of local citizens, (e.g., retail sales, agriculture), or related somehow to national security. These may be sectors in which only a modest foreign input is needed, if any. By limiting entry, a society may endure
a higher cost, because of reduced competition or reduced quality of output, but it may be felt that if a foreign-controlled company owns and operates, say, a power plant, the host society has lost an important element of control.

Virtually all countries also reserve certain sectors to the government, or to government-owned enterprises. The motivation is varied and may include: (1) inherent distrust of private enterprise to serve the general well-being, particularly in a small market where the possibility of monopoly pricing is great, (2) the desire to use an enterprise in part as a training institution as well as a production unit, (3) the use of an enterprise as a developmental institution in order to stimulate production of a raw material (and the time before a profitable level of operation can be reached is too long to attract private investment, for example, a meat packing plant in eastern Turkey in ideal range country, prior to the establishment of private herds), (4) the compelling need to employ large numbers of people so that the enterprise is considered in part to be a supplier of public welfare, or (5) where some generalized subsidy is desired, such as supplying energy or skilled manpower below full cost.

The real danger is the reservation of productive sectors to the government without a careful weighing of social and economic benefits and costs. In all cases, there is need to establish clearly defined performance criteria for the management of government-sector enterprise if the objectives are to be well served, even though these do not include internal financial profit.

As noted, in some countries, foreign-controlled enterprises are rewarded for selling some portion of their shares to the public (as in Brazil). A problem arises if the foreign owners have interests that are at odds with the local public owners. Even with a minority holding, the foreign owners may have effective control if the majority
is held by many thousands of people. Interests may diverge in terms of dividend payout rates or prices charged the local firm for goods and services provided by associated foreign firms, to name only two areas of possible conflict.

In order to stimulate the development of locally-owned and managed enterprises, a number of governments are now insisting that foreign companies release ownership and management control over a specified time. In some cases absolute restrictions are laid down, as in the Andean Common Market countries: in others, substantial inducements are offered, such as entry into otherwise closed sectors (the Philippines).

A serious defect lies hidden in the concept of time-limited foreign ownership, or fade-out notion, which India and Indonesia introduced and which has now been taken up by many countries. This defect lies in the fact that between 100% foreign ownership and something less than 50% foreign ownership (the exact point depends upon how the local ownership is held) one has a foreign-controlled joint venture. Such a venture is a nest of conflict of interest in that substantial differences in perceptions and policies are very likely to emerge between the foreign and local owners. Characteristically, the former is a large corporation operating internationally and the latter, a relatively small national firm - or worse yet, merely a group of local financial investors. Risk perception and time horizons are very likely to be widely divergent. In fact, the local firm may not even be seen as a profit center by its international parent. Depending upon the degree to which the parent operates an internationally-integrated system (measured by the volume of goods and services moving across national frontiers among associated companies), it will generate profit where it is to its greatest advantage to do so.
If it has the option of generating profit in a 100%-owned subsidiary as opposed to a 60%-owned subsidiary, one would expect it to choose the former. Why share it? Being in a controlling position vis-à-vis a subsidiary, the parent can dictate prices of goods and services moving in both directions to the extent permitted by taxing and customs authorities. The parent may extract profit via dividends, interest, royalties, fees, discounts on purchases, commissions on sales, cost absorption (e.g., central overhead allocation, personnel). The noncontrolling partner or investor in the subsidiary is at the complete mercy of the parent firm. And, as the controlling position of the parent international firm is finally threatened, it is very likely to stem any new investment, transfer of technology, or market development. By the time local investors finally have control, 10 or 20 or 30 years out, they may not have very much. And how is a fair price for the divested equity to be determined in the absence of an efficient stock market? There is no obvious formula, for the "true value" of an enterprise is equal to the present discounted value of future earnings. Rational people may well differ in the selection of the appropriate discount rate and in their expectations in regard to future earnings.

Risk is perceived as different because of the relatively larger portfolio of investments held by the international parent than the local investor in most cases. The former can tolerate a higher level of risk and uncertainty in respect to any single investment and thus will invest where the local investor would not. That is, the local investor is likely to demand a higher profit. Furthermore, the time horizon of the large international company is likely to be much longer. The trade-off between present and future cash payout is possibly quite different from that of the local investor, who typically has a much shorter time horizon. The point is that investment in the
subsidiary of a large international company is unattractive from the point of view of a local investor. And as the point at which the foreign owner will lose control is approached, the true value of the enterprise is very likely to fall.

In imposing a requirement that foreign firms divest themselves of equity at some point in the future, the host government faces something of a dilemma in regard to foreign-owned enterprises already operating within the country. Should it enact a "grandfather clause" to the effect that old investment is exempt from the divestment requirement? If it does, and the new divestiture law tends to slow down or block new foreign investment, which it will, entry is to some extent limited. But wherever entry is limited, those already in the market gain some degree of monopoly power. The Mexican law limiting foreign ownership contains such a "grandfather clause," but to prevent existing foreign-owned firms from gaining monopoly power, the Mexicans specified that any new investment by an existing enterprise should fall under the same restrictions faced by a new investor entering Mexico. New investment by an existing enterprise was defined as expansion of plant onto a new site or expansion of production into a new product line. Obviously, definitional problems still remain. Does the enlargement of a building on land already owned by the enterprise constitute plant expansion under the law? How different must a product be from one manufactured presently in order to constitute a different product line?

But, so as to avoid these problems, let us assume that the host government does not include a "grandfather clause"; new and old investment are treated alike. In that case, since forced divestment at a specified time was not a condition of entry for old investment, the owners of that investment can claim that their property is being expropriated. Furthermore, potential new investors
will perceive that the host government may impose unexpected costs after entry on their investment, as it has done to former investors. The rate at which future earnings are discounted goes up, and the inflow of foreign investment may be reduced substantially.

All things considered, it may make more sense for a host country to impose, as a condition of entry, a requirement that the foreign firm make available for sale in the host country a certain number of shares of the parent corporation itself and to require access to the corporate planning process. Possibly, national shareholders could be organized at the national level and represented collectively via a representative on an appropriate advisory committee or board. No nation yet seems to be pursuing this approach actively, although at one time Australia was reported to have demanded that foreign firms with local subsidiaries market some shares in the parent companies locally.

It also makes more sense for foreign ownership, if it is to be forced out, to be eclipsed totally at some point, without a "fade-out," but well after the possibility of a continuing relationship with the foreign corporation via contract has been discussed. In such case, the ideal would be for the foreign firm to move from 100% ownership to zero ownership, but with a carefully worked out contractual relationship on which basis the foreign firm would continue to provide needed inputs (new technology, foreign market access, etc.) at carefully negotiated prices and controls (e.g., quality control).

If a government is worried about the undue profitability of foreign-owned enterprises, the limitation of profit remittance to a given percentage of registered capital will not be very effective unless all flows between foreign parent and local subsidiary can be controlled, which requires an enormously cumbersome bureaucratic apparatus. The result is great opportunity for corruption and a major disincentive for investment. A profit tax which is progressive
in relationship to rate of return on registered capital will certainly reduce after-tax profits, but will likewise be ineffective unless all other flows are controlled. The point is that fees, royalties, purchases, commissions on sales, interest, allocated overhead expenses are all deductions from taxable income.

Rather than the control-of-profits approach, that suggested by Taiwan may be cheaper and more effective, namely, measures to step up competition in the market by reducing tariffs and releasing controls on imports, also by assisting local firms acquire the necessary technology so as to compete.

E. Technological Development. An important concern of many governments is creating an indigenous technological base. The development and application of technology which is appropriate to the factor "mix" of a country (labor, capital, skills, resources, land, energy), and therefore to its relative costs, is critical in securing the optimum use of a country's resources, physical and human.

Many countries offer some sort of incentive to local research and development activity by way of grants and tax write-offs. Research and development is a very capital-intensive activity, and there is much evidence that to be productive it should be located near production facilities and within a major market. A substantial scale or size factor exists.

Some countries attempt to increase scale factors by offering inducements to integrate, consolidate, or rationalize an entire industry, and possibly even limiting new entry in order to induce or force such restructuring. Policy-makers should be aware that in so doing they are creating a monopolistic or oligopolistic situation in which output restrictions and price maintenance may maximize profit for those producers lucky enough to be within the protected market,
but at the expense of the consumers. In the absence of price control, the added cost to the society as a whole can be substantial, but price control by a government is very likely to dampen any investor's enthusiasm about entering a particular sector. The rate of return then becomes subject to government decree, which is seen frequently as being arbitrary.

Another instrument relating to technological development is the technology transfer contract which sets out the terms under which a domestic investor secures foreign technology in return for a lump sum payment, periodic payments (fees and royalties), a portion of ownership in the receiving firm's assets, or a combination of these. Payments for technology are frequently subject to ceilings (for example, in Mexico) and the contract itself has a limited life, after which payments are terminated. Moreover some countries (e.g., Korea) ban the repeated import of the same technology. Other countries (e.g., Mexico) refuse to patent technology in certain sectors, or offer very limited protection of technology through patents or secrecy.

Introduction of controls over the importation of foreign technology are particularly troublesome and may result in penalizing local firms vis-à-vis foreign-owned subsidiaries. Very frequently a country (e.g., Mexico, Brazil, ANCOM countries) prohibits certain restrictive clauses in the writing of license and technical assistance contracts. Classic examples are clauses restricting the licensee's or contractee's right to export the products covered or to determine production levels, providing for a free grant-back of locally-developed technology, and requiring purchases of goods and services from the technology supplier. For a purely local firm to buy technology without such restrictions may be very costly. Indeed, it may not be available to it at all. But for the local subsidiary of a foreign
company, these prohibitions are irrelevant; the foreign parent controls its subsidiary in any event. It need not have any specific agreement in respect to exports, grant-backs, tied-buying; it will simply direct its subsidiary to conform as a perogative of equity-based control. Hence, the technology flows more easily to subsidiary than to locally-owned (and controlled) firms. And if contracts between foreign parent and local subsidiary are forbidden, local costs are thereby reduced and profits enlarged. If profits are limited to a percentage of registered capital, either the capitalization may be increased or the flow of goods and services moving between parent and subsidiary priced so as to carry a heavier commission and discount burden in favor of the parent.

A related problem has to do with insistence that investors employ only the newest and most sophisticated technology. For example, some countries prohibit the import of used machinery; others, its incorporation into the capital of an enterprise (Egypt). Granted, there may be difficulty in assessing quality and value, but independent and reputable firms do exist whose business it is to determine the quality of, and affix a value to, used capital equipment. The certification by such a firm might be required before accepting such equipment either as an import for sale or for capitalization by either foreign or domestic investor. It should be recognized that differing factor costs between nations may well mean that production equipment no longer appropriate for one might be eminently appropriate for another. The real danger lies not in the import of used equipment, but the utilization by foreign firms of the same production processes used in their home countries in which capital/labor costs may be very different. There is probably a demonstrable tendency for Western European, North American, and Japanese-based firms to use overly capital-intensive production
processes in their plants located in lesser-developed countries. Some of the reasons for this tendency are: the cost of developing a new, more labor-intensive technology; the greater ease of managing a more capital-intensive plant; the tendency of many LDC's to reduce the cost of capital via subsidy and tax incentive and increase labor cost via various social welfare programs; the desire of the international firm to standardize product and technology worldwide; the greater "economic rent" the firm may extract from capital-intensive technology; the greater control the foreign firm can maintain by using new and complex technology via the need for foreign technical experts.

At this point, it may be useful to turn to some of the specific administrative devices used to influence the flow of investment and technology.

4. SOME ADMINISTRATIVE DEVICES

A. Foreign Exchange Controls. A foreign exchange control system implies overvaluation of the local currency in respect to key foreign currencies. This overvaluation of the local currency (overvaluation as compared to the clearing value on a free market) has the effect of taxing exports and subsidizing imports. This fact may force the restriction of imports by licensing and the promotion of exports by means of some variety of subsidy, such as reduced taxes (e.g., tax rebates). One device used is to permit an exporting enterprise to retain a certain percentage of the foreign exchange received (Jugoslavia's "retention quota") to be used freely for imports. If the same firm does not both export and import, it is penalized; hence, the creation of a "parallel market" (as in Egypt)* in which firms may sell and buy foreign exchange.

* Apparently to be discontinued in 1979. (See page 45).
An overvalued currency also has the effect of subsidizing local businessmen borrowing overseas, as well as the local subsidiary of a foreign firm. In both cases, the local earnings buy more foreign currency than would be possible on a free market. Those buying the foreign currency, gain; those selling it, lose. At the same time, inbound investment is likely to be discouraged, because the price of local assets may be seen to be relatively high and the translation of foreign capital assets into local currency terms may be felt to be inadequate. This latter becomes particularly important if the corporate income tax is progressive, and taxable profit is calculated as a percentage of registered capital. It is likewise important if foreign exchange with which to remit earnings is limited to a percentage of registered capital, as in the ANCOM group.

It should be recognized that by intervening in the foreign exchange market, what the government is saying is that the market will not allocate foreign-sourced goods and services in an optimum way from the point of view of government policy and programs. That is, the government is enforcing its consumption function on the market, for example, by forcing the use of foreign exchange for the purchase of investment-related goods and services rather than consumption-related.

Another relevant problem has to do with the unequal treatment of foreign and domestic investors. A government may, in order to attract foreign investment or technology, guarantee the availability of foreign exchange to repatriate profits, dividends, interest, fees
and royalties. But a similar guarantee is rarely available to domestic investors or suppliers of technology. Further, as already noted, unless a different exchange rate exists for such outbound financial transfers, those transfers are likely to be subsidized because of the tendency of the local currency to be overvalued. The result is that a society may end up paying more for foreign capital or technology than it realizes. Furthermore, this subsidy pushes in the direction of greater capital intensity and the use of more sophisticated technology than may be justified.

B. Credit Incentives. It should also be noted that if local interest rates do not fully compensate for the rate of inflation, the borrower is subsidized and the lender, taxed. Therefore, the incentive to save and invest may be jeopardized unless compensated for through forced savings, such as taxation and government savings and investment. Concessionary credit terms, or a credit subsidy may lead to overexpenditure on fixed capital (land, buildings, machinery) unless credit is available on the same terms for working capital. Even so, of course, any capital subsidy tends to decrease the cost of capital relative to labor and thus increase the capital-intensity of investment. The same effect is produced by accelerated depreciation privileges or the duty-free import of capital equipment, or even the tax-exempt status of highly skilled foreign technicians. All tend to reduce the cost of capital-intensive investment and, hence, discourage labor-intensive investment and reduce the employment generated per investment dollar.

C. Tax Incentives and Subsidies. It is a curious fact that only two countries (Singapore and Egypt) in our sample discriminate in the granting of tax concessions against investment sourced in countries which would negate that tax concession. The point is that the taxing policy of the investor's home country may eliminate any benefit from
a tax holiday if that government taxes worldwide income and only allows a credit for foreign profit taxes actually paid. The United States and a number of other capital-exporting countries pursue this policy, which means that unless the investor reinvests his profits abroad he derives no benefit from a holiday on profit or wealth taxes. And, even if he reinvests abroad, the investor will eventually pay the foregone tax to his own government when he repatriates his profit. The revenue which the host country foregoes is simply transferred to the treasury of the investor's home government.

Some capital-exporting countries tax foreign-source earnings at very low rates or not at all, in which case the tax holidays given by other countries become fully effective. Certain other countries, such as Japan, recognize the "tax-sparing principle": that is, they credit foreign taxes waived against a firm's home country tax liability.

It might be prudent for a host government to stipulate that tax holidays be given only to those corporations whose parent government either does not tax foreign-source income or recognizes the tax-sparing principle. Note that although a subsidy presumably adds to the taxable profit of a firm, a subsidy would never be taxed away completely as might the gain from a tax holiday. Furthermore, exemption for a tax other than an income or wealth tax simply adds to profit and so, like a subsidy, would not be taxed away completely by the home government. One country, Ireland, has negotiated treaties incorporating the tax-sparing concept, which permits a tax not paid to be credited against the foreign investor's tax liability at home.

A difficulty with an exemption for any form of income or earnings tax is that its effect is not known to either the government or the investor at the time of the investment decision. The government does
not know how much revenue it is losing, nor does the investor know how much he is gaining, until the enterprise is in operation and the profit is known. On the other hand, the amount of a grant is known at the outset, as the government is generally obligated to pay the grant whether the enterprise eventually makes a profit or not. Also note that a profit-tax holiday does not become operative unless or until there is a profit.

It is probably true that a direct grant or subsidy is more likely to achieve a desired impact without counterproductive secondary effects. For example, a payroll tax to finance the training of skilled labor adds to a firm's labor cost and thus induces it to substitute capital for labor. A training subsidy would reduce the labor cost. Likewise, the elimination of import duties on capital equipment out of a desire to promote employment by increased investment in productive capacity, may in fact increase the capital intensity of industry by rewarding the use of capital (that is, reduce its cost), but not of labor. Note Ireland's use of grants and the relative success of its program.

It might be much more productive to pay an outright grant for each man-year of employment offered. The difficulty with that approach, however, is that the payment of money to a firm is much more visible politically, particularly if foreign-owned, than exempting a firm from a tax.

D. Guaranties. The point is made over and over by investors that the important thing about government intervention in the market is that it not be done in a discontinuous manner as viewed in the short run. That is, if an investor can assume that imposed market conditions (in contrast to those commercially induced) will remain more or less unchanged for, say ten years, risk and uncertainty are substantially reduced. Likewise, the rate by which future earnings will be discounted to the present are significantly lower, and investment takes place at
much lower expected return rate. To minimize the cost of savings (foreign and domestic), a government should alter the means and degree of its market intervention as little as possible, and then only by small amounts so as not to introduce sharp discontinuities.

A history of discontinuous and unexpected market intervention by a government may be very costly in terms of future investment, possibly in terms of the prices of goods and services as well. For example, if a government suddenly introduces a 50% tax increase on fees and royalties paid to foreigners, the cost of future technology transfer is likely to increase by substantially more than 50%. It is not so much the fact of government intervention which leads to heightened risk perceptions and higher costs, but rather the sudden and substantial changes in the nature and degree of that intervention, which is tantamount to changing the rules without warning.

Consequently, the notion of an entry contract or agreement is not looked upon entirely with disfavor by foreign investors, provided there is some reasonable assurance that the host government will live up to its side of the bargain. Such an agreement is designed to stabilize the relevant conditions, to eliminate unpleasant surprises. A stipulated willingness to submit disputes to external arbitration, such as to the International Centre for the Settlement of Investment Disputes, probably makes it possible for the host government to extract substantially "more favorable" terms from a prospective investor or supplier of technology and skills than would otherwise be the case. Although one can easily understand the felt need on the part of many governments (e.g., most of those in Latin America) to insist on local arbitration, the cost of such insistence should be recognized. Significantly, many of its Eastern Bloc countries now permit third-country arbitration.
A host government guarantee against expropriation without fair, adequate and prompt compensation may be reassuring to the investor or contractor, provided the country has not had a recent record of doing precisely the opposite. In any event, rational and well-intentioned people can differ on the precise operational meanings of fair, adequate, and prompt. But if the host-government guarantee be underwritten for a reasonable fee by a similar guarantee -- and assumption of contingent liability -- by the parent government the guarantee takes on more meaning. Nonetheless, many investors feel that if the possibility of expropriation within the relevant time horizon (rarely more than 10 years) is such as to warrant taking out insurance, then the project is not attractive. In such case, the expected payout has to be high and fast, which fact may simply compound the political risk. Another deficiency in the investment guarantee programs generally has been the reluctance with which parent governments have been willing to provide coverage against breach of contract and losses incurred thereby.

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This brief essay only highlights some of the problems associated with government intervention in the market through incentives, disincentives, and restrictions. The full impact of the factor and product price distortions caused by such interventions should be taken into consideration in anticipating how the private business decision-maker, foreign and domestic, is likely to respond. Only then can the public policy-maker have some assurance that the strategies he uses will produce the intended results at acceptable cost.
II. CLASSIFICATION AND EXAMPLES

At one level of generality, there are seven types of national investment and technology promotion and control approaches, specifically:

Type 1. Virtually unrestricted entry and little attempt to influence flows of direct foreign investment and technology, (i.e., license, technical assistance and management contracts).

Type 2. Virtually unrestricted entry, but with incentives rewarding those flows deemed to be especially supportive of national policies.

Type 3. An entry-screening process barring those flows deemed to be incompatible with national objectives.

Type 4. Selected, negotiation entry, with foreign ownership (or contract) limited in time.

Type 5. The socialist model in which foreign direct investment is limited to minority participation in a joint venture.

Type 6. The more restrictive socialist model which bars all foreign direct investment, but permits technology contract.

Type 7. The virtual prohibition of all direct foreign investment and technology contract.

Examples of Types 6 and 7 are not included in the following country analyses for they do not appear relevant to the purpose of this study. Let it be noted that a government, in shifting its policy, from say Type 1 to Type 4, need necessarily pass through the intervening policy types.

Further descriptions of each of the first five types, with a country example of each, appear below (starting on page 29).
National investment promotion policies are multidimensional in that they may be classified in many different other ways, specifically:

1. By political objective (that is, objectives developed by a political process for which there is no necessary economic rationale):
   
   (a) To internalize (nationalize) control over resource allocation,
   
   (b) To localize (that is, reduce dependency on external sources for) inputs -- skills, technology, goods, research and development,
   
   (c) To diversify or change the national sources of foreign inputs,
   
   (d) To redistribute income (by economic or social class, by ethnic or religious group, by sector, by region),
   
   (e) To induce changes in population distribution or to prevent such changes,
   
   (f) To induce a greater sense of participation (for example, to force public or employee ownership and/or participation in decision-making),
   
   (g) To socialize the means of production,
   
   (h) To gain international prestige,
   
   (i) To induce full employment,
   
   (j) To effect greater international regional integration, and/or
   
   (k) To effect greater international integration.

2. By economic objective (that is, the stimulation of aggregate national economic growth, which is itself a political decision):
   
   (a) To utilize more "appropriate technology,"
   
   (b) To gain economies of scale,
   
   (c) To generate an optimum level of competition,
   
   (d) To utilize relatively cheap foreign inputs (for example, savings, technology, skills, resources),
(e) To generate a viable balance of payments (for example, by promoting exports),

(f) To modernize (that is, to gain more productive technology, often more capital-intensive), and/or,

(g) To improve local skills (e.g., by training programs).

3. By scope of government control or intervention in respect to foreign investment:

(a) For all foreign investment (direct and portfolio; debt and equity; capitalized goods and services and rights; new investment and re-investment),

(b) For all foreign equity investment,

(c) Only for direct foreign investment which places the foreign interest(s) in a controlling position (sometimes in specified sectors or activities),

(d) For none.

4. By degree of government intervention in respect to foreign contracts:

(a) For all contracts,

(b) Only for contracts in specified sectors and/or between related parties,

(c) Only for certain types of contracts (patents, copyright, trademark, commercial secrets, technical assistance, construction up to and including turnkey),

(d) For none.

5. By stage of development and commercialization of technology

(a) During the investment stage: idea generation, idea evaluation, business and technical feasibility analysis, technical R&D, product R&D, preliminary production, market testing, commercial production.

(b) During profits stage: introduction, market development, rapid growth, maturity, decline, abandonment.

6. By administrative device:

(a) Foreign exchange controls or incentives,

(b) Restrictions or prohibitions (by sector, function, region, enterprise size, etc.),

(c) Guaranties (for example, in respect to nationalization, compensation in event of expropriation, foreign exchange availability, arbitrary breach of contract, recognition of foreign arbitration, national treatment under law),

(d) Credit incentives/disincentives,

(e) Tax incentives/disincentives

(f) Market protection (tariff and non-tariff barriers), and/or

(g) Subsidies

For the purpose of the following country analyses, some of these dimensions have been merged. Others have not been treated at length. Each country statement begins with a brief discussion of political and economic objectives to the extent these have been articulated (#1 and 2 as listed above). Next comes a brief summary of the scope of government control over both foreign investment and technology flows (#3 and 4). A third section specifies some of the details in regard to the administrative devices used by the Government as listed in #6 above (and incidentally #5). The fourth and final section in each case consists of a brief evaluation.

Examples of the general policy types follow.

**TYPE 1 - VIRTUALLY UNRESTRICTED ENTRY -**

No country has a policy of permitting completely unrestricted entry. Even the most liberal insist on limiting equity investment in certain sectors to local nationals. In some instances, foreigners are permitted to invest in such restricted sectors, but only up to specified percentages (such as the U.S. 25% limitation of foreign ownership of domestic corporations with operating telecommunications licenses). Restrictions on the foreign ownership of agricultural land over a specified acreage are not uncommon. Several states of the U.S. have such limits on their statute books. Other commonly restricted sectors include: defense-sensitive industries, power generation, domestic transport, and mining. Although
few "Type 1" countries limit the purchase of foreign technology and skills via contract, all have some restrictions on the employment of foreign personnel. Likewise, all governments protect certain categories of domestic economic activity either through prohibitions, tariffs, or non-tariff barriers. Also, many impose an export licensing system on certain goods and technologies, such restrictions being a function of the domestic supply situation, the defense-relevance of the export, and the political relationship with the country of destination. Finally, all countries maintain a maize of internal taxes and regulations impacting on business, whether of foreign or domestic origin. Regulation is particularly common in such areas as: banking, insurance, the marketing of securities, product and service standards, product liability and environmental impact. Modest investment incentives (often limited to impacted or high unemployment regions) may be given.

In a federal system, such as the U.S., the latter may be granted by certain subnational units - states or municipalities. An example of one of the most liberal policies is that of Hong Kong.

Example: HONG KONG

The posture of the British Crown Colony of Hong Kong toward foreign investment and technology is an example of policy Type 1. It makes no distinction between foreign and local firms and welcomes foreign investment. Indeed, in few places in the world has a government subscribed so nearly to the notion that the best government is the least government. The official Hong Kong policy is that economic enterprise should be left wherever possible to private hands. Only the low-cost housing estates, water supply, railway, airport, and postal service are run by the Government.

1. POLITICAL AND ECONOMIC OBJECTIVES.

The Government does not seem to be pressing on any major objectives. The Colony's 4.5 million residents enjoy Asia's third-highest standard of living (after Japan and Singapore). For the long term, Hong Kong
continues to emphasize the development of transportation and infrastructural facilities. Its overriding objective is to maintain its status as a virtual free port and to participate in international trade. Possessing few natural resources, Hong Kong is greatly dependent on imports to supply its export-oriented manufacturing industries. The fact that under the terms of the British Lease, Hong Kong reverts to China in 1999 does not seem to have disturbed the business climate.

2. SCOPE OF GOVERNMENT CONTROL.

There are no restrictions on the entry of foreign investment, nor on the import of foreign technology. Licenses and technical assistance agreements may be entered into freely by local and foreign enterprises.

3. ADMINISTRATION DEVICES.

A. **Foreign Exchange Controls or Incentives.** None

B. **Restrictions.** For twelve years – until 1978 – Hong Kong issued no new banking licenses. (Subsequently, nine foreign banks have been licensed as of June 1978).

C. **Guaranties.** Via the U.K., Hong Kong participates in the International Centre for the Settlement of Investment Disputes (ICSID).

D. **Credit Incentives/Disincentives.** None.

E. **Tax Incentives/Disincentives.** Prior to April 1978, Hong Kong did not tax interest income of financial institutions if paid on capital coming from outside the colony. Subsequently, the 17% profits tax levied on all income generated by an institution's activities (with an exception only if there is "substantial intervention" by an overseas affiliate of the Hong Kong institution).

F. **Market Protection.** None.

G. **Subsidies.** All land in the Colony is owned by the Government, which sells land leases at public auction. Under a so-called "modified land policy" recently introduced, it is now possible for the Government to make special arrangements for selling leases to "qualified purchasers".
Under the scheme, the Government sells the land lease not by public auction, as is the usual practice, but at a concessional price to an investor whose projects meet one or more of the following criteria:

- The proposed investment is either in an industry that does not yet exist in Hong Kong, or its technology standards result in significant improvement of local standards.
- The technological production standard of the proposed enterprise itself is higher than the Colony's existing standard.
- The proposed investment offers employment for technically-trained staff, especially men.
- To be admitted to an industrial estate (of which there are several), the proposed investment must be unsuited for operation in a multi-story industrial complex.
- The proposed investment is of a type that actually requires a new land site - that is, one which cannot be accommodated in multi-story factory buildings, which are the common type of plant structure in Hong Kong.

Of particular interest to the Government is investment in medium and heavy engineering, such as the manufacture of hand tools, light machinery, automotive components, precision instruments or other new and high-technology products.

The Hong Kong Development Council has been established to assist foreign investors. It maintains a number of foreign offices in major investment centers.

5. EVALUATION.

As of mid-1976, cumulative foreign investment in manufacturing alone was about HK$ 1.77 billion (about $350 million). At that time, 920 foreign firms were operating in Hong Kong (compared with 878 in June 1975), and 291 factories were either fully or partly owned by foreign interests.
Gross Domestic Product has been growing at about 7% annually. Unemployment and inflation have been at modest levels. Therefore, it would appear that Hong Kong has been doing an excellent job in exploiting its position. It should be noted that Hong Kong enjoys a highly advantageous geo-political position, a long-standing tradition of honest and efficient government, and a hardworking indigenous population skilled in international trade and finance.

TYPE 2 - VIRTUALLY UNRESTRICTED ENTRY, BUT WITH INCENTIVES -

The major administrative difference from Type 1 is that Type 2 countries require the registration of incoming direct investment and some (Ireland and Venezuela), of technology contracts as well. In substance, the difference between Type 1 and 2 is essentially one of degree; in the Type 2 case, the incentives are national in scope and are designed to be of major importance in rewarding flows of investment and technology deemed to be especially supportive of national policies. These incentives may be essentially in the nature of subsidies (as in the case of Ireland) or come largely in the form of tax incentives (as in Brazil and Taiwan). The number of sectors open to direct foreign investment varies. In the sample of countries discussed here, Ireland is the most liberal in this respect, with prohibitions against foreign investment only in the sugar, electricity, and domestic air and rail transport. Thailand has issued a list of activities in which majority foreign-owned firms may not participate. Although Thailand has a general prohibition against the foreign ownership of land, a "promoted company" is an exception. In Type 2 countries, the emphasis is on incentives rather than restrictions. The policy of Ireland is an example:
Example: IRELAND

A policy of virtually unrestricted foreign entry is maintained, but projects may qualify for a rich basket of incentives if they satisfy certain guidelines. Hence, Ireland's investment promotion policy is of Type 2 variety.

1. POLITICAL AND ECONOMIC OBJECTIVES.

Possibly the main reasons for the election of the Fianna Fail Party in June 1977 were popular dissatisfaction arising from inflation and unemployment. The new Government came to power with a vigorous program to tackle both, as well as to boost industrial expansion and agricultural output through a massive export effort. The object was to create 20,000 jobs within one year. The new administration has also been promoting mining exploration and the local processing of natural resources, including agricultural products, oil, lead and zinc, so that downstream industries can be developed. The Government has announced its intent to maintain control of the processing of ores, oil and gas, so as to ensure more value added in Ireland.

Ireland, of course, became fully integrated with the European Economic Community on July 1, 1977, insofar as trade policy is concerned. Although the country has been a strong EEC supporter, there may be difficulties if the EEC Commission takes vigorous exception to Ireland's package of incentives for foreign investors.

Basically, all political parties seem to favor emphasis on private enterprise, encouragement of foreign industrial investment within the context of Government guidelines, full regional integration, and an open economy generally.

2. SCOPE OF GOVERNMENT CONTROL.

Foreign investors require Ministry of Finance approval, which is readily given for investments that aid industrial development. If the firm seeks incentives, further approval is needed from various Govern-
ment agencies. In addition all license and technical assistance contracts require approval, which is given routinely provided the relevant documents are in order.

3. ADMINISTRATIVE DEVICES.

A. Foreign Exchange Controls or Incentives. For purposes of exchange control, the world is divided into "scheduled territories" (essentially the United Kingdom) and the rest of the world. The latter falls into four categories: The Overseas Sterling Area, the EEC member countries other than the U.K., Rhodesia, and the "Rest of the Non-Scheduled Territories." Payments to scheduled territories are not subject to control; others require approval. Foreign currencies received must be offered for sale to an authorized bank. Inward and outward movements of capital between Ireland and "other scheduled territories" are not subject to control. Inward direct investment from outside the "scheduled territories" requires exchange control approval, and net inflows into banks may be subject to guidelines set from time to time by the Central Bank. Special approval is required for payments exceeding £2,000 (about $3,600) to non-Sterling areas.

B. Restrictions. Permission must be obtained from the Central Bank for ordering goods originating outside the Sterling Area for delivery more than 9 months after the order date or for those not to be consumed domestically. A system of export licensing is applied to a limited range of goods, likewise for imported goods. Some of the non-EEC goods requiring export license: agricultural products, clothing, textiles, footwear, bicycles, private cars, certain types of buses and trucks. Ireland's tariffs became fully integrated with those of the EEC on July 1, 1977. Exports of certain goods may be prohibited if in short domestic supply.

There is very little real government involvement in business activity. It does hold an option for a share in companies (up to 50%) engaged in mineral exploration, particularly oil, and it is
generally encouraging joint ventures between foreign and domestic firms. The Government owns about 80% of the country's mining rights, which are leased to both foreign and domestic firms. Government-owned companies may be created when private enterprise is unwilling to undertake new activities of potential national value. The Industrial Development Bill of 1977 authorizes the Industrial Development Authority to take a majority share in a company.

Foreign investors, other than those in "Scheduled territories," must gain the approval of the Ministry of Finance, but approval is readily given for any project contributing to the economy. If the company seeks incentives, it will additionally need the approval of various agencies. Foreigners may not invest in the sugar, electricity, or air and rail transport systems, but otherwise there are no limits on foreign equity in an Irish company. Local permits are required for construction and the discharge of industrial effluents. The transfer of farmland to non-Irish persons has been restricted. Although recently declared invalid by the European Court of Justice, this restriction is likely to be phased out only slowly.

Restraint of trade is illegal unless it is deemed reasonable. The Restrictive Practices Commission deals with such practices as limitation of entry, resale price maintenance, price fixing by trade associations, conditional sales arrangements, coercion of suppliers, and restrictive arrangements with external associations.

The Government has the authority to control prices and profit margins for both goods and services. Only companies which can demonstrate that at least 25% of their output is exported and that their domestic price is no higher than their export price, are exempt. There are strict regulations over consumer financing.

Ministry of Finance approval is required for royalty and fee arrangements, which is routinely given if the terms are deemed reasonable.
Contracts between a parent and a local subsidiary may be examined somewhat more closely.

Employers of foreign nationals, other than of the United Kingdom and Northern Ireland, must obtain work permits. These are freely given when the employee has skills not available locally or special knowledge of value to the country. Restrictions on EEC nationals were phased out in January 1978.

Although any new industry may receive incentives, export industries are favored. Also, special treatment is given in the western part of the country and at Shannon Airport. Ownership is not relevant. In order to speed approval, applications normally include a feasibility study, indications of conformity to the norms for jobs and exports developed by the Industrial Development Authority (IDA) and the stipulation of a location within an IDA-designated area. IDA may reject an application for a project that is deemed harmful to the environment or is only viable on the basis of cheap labor. Approval is normally given within two weeks, unless large subsidies are involved (over £ 850,000, or about $1,530,000).

C. Guaranties. Nationalization and expropriation are not issues. A system of export insurance operates which offers coverage up to 90% for both commercial and political risk. The Finance Ministry will, on request, guarantee the right to free transfers at the rate of exchange at the time of the transfer. Capital-intensive projects may receive IDA guarantees on interest and principal of foreign debt used to finance manufacturing projects in Ireland, sometimes on a local debt as well. Ireland is a signatory of the Convention on the Settlement of Investment Disputes Between States and the Nationals of Other States.
D. Credit Incentives/Disincentives. The Industrial Development Authority has been providing standard factories on its industrial estates either for sale or lease. The IDA may also subsidize interest rates for funds borrowed for the construction of IDA-approved manufacturing plants. The Government-sponsored Industrial Credit Company operates as a capital underwriter for small and medium-sized firms, largely in loan form. It also participates in the equity of industrial undertakings. Foir Teranta, another state-sponsored organization, provides assistance for industrial concerns in danger of closing because of inability to raise capital from commercial sources. In both cases, terms are normally commercial.

E. Tax Incentives/Disincentives. Tax incentives are given to IDA-approved projects. First, profits attributable to export trade in Irish-manufactured goods (the ratio of export to total sales) are eligible for complete relief from corporate income tax up to 1990. (According to Ireland's treaty of accession with the EEC, it can offer only full relief up to that time.) Second, dividends paid out of tax-exempt income are not taxed to the recipient. Third, duty-free or reduced-duty entry of raw materials and equipment is available.

Some of Ireland's tax treaties contain a tax-sparing provision, which permits the foreign parent to treat taxes waived by the Irish Government as though they had actually been paid for purposes of calculating tax liability in their home country. Neither the U.K. nor U.S. treaty has such a provision.

F. Market Protection. There are a few specific quotas on goods which compete with home-produced goods. Apparently, such protection is not normally available as part of the industrial incentive package.
G. Subsidies. Ireland makes more use of subsidies and grants to encourage new industrial undertakings than any other country in the world. For approved projects, the IDA provides cash grants toward the cost of fixed assets, including site and site development, buildings, and new machinery and equipment. Such grants may be negotiated up to 60% of cost in the comparatively underindustrialized western areas of the country and up to 35% in most other areas, except where industrial development generally is not encouraged.

In situations where the IDA provides a grant equal to 35% of fixed assets, the company must provide at least 35% of the total out of its own resources. The remaining 30% may be borrowed locally or abroad. When IDA provides 60%, the firm must still provide 35%. These ratios apply where the investment in fixed assets does not exceed £ one million (roughly $1.8 million) or where the amount of investment per job does not exceed £ 6,000 (about $10,800). For larger and more capital-intensive projects, special incentives may be negotiated. Generally, grants for capital-intensive projects are based on the number of workers and range up to £ 8,000 ($14,400 per worker). Projects eligible for larger grants are characterized by one or more of these factors: high male labor content, employment for skilled workers, advanced technology, use of local raw materials, linkages with existing or projected new industries, a high potential-to-risk factor, a high local value-added.

Grants are also used to cover wages of workers during their training in Ireland as well as abroad (travel, wage, and living cost). Grants may be given to cover management training costs and the cost of instructors and consultants engaged to locate personnel.

Firms expanding local facilities may receive £ 20 per week (about $36) for each unemployed worker hired and £ 10 per week for each school dropout.

Grants are available for infrastructure development and for the rental of factory space for up to 10 years, depending upon location.
Research and development projects may qualify for cash grants up to 50% of the cost of an approved project, or €15,000 (about $27,000) whichever is smaller. A manufacturing firm may also qualify for a grant of up to 50% of the cost of consulting. And finally, grants up to 50% are available for the repair, improvement and renovation of tourist facilities.

4. EVALUATION.

It is quite clear that Ireland leans heavily on subsidy rather than tax incentive. In so doing, at least two advantages are realized: (1) the amount of the subsidy is generally known by both Government and recipient at the outset of a project (a tax incentive based on earnings is not), and (2) such an incentive is effective even in respect to foreign enterprises owned by parent firms lodged in countries whose governments tax them on the basis of worldwide income and do not recognize the tax-sparing principle.

By all measures the efforts by Ireland to stimulate industrial development, particularly direct foreign investment, have been dramatically successful. Foreign firms now employ more than one out of every four industrial workers. By 1980, it should be closer to one out of three. From the inception of the subsidy program in 1952, designed primarily to attract foreign investment, to 1973, the Irish Government approved 1,139 industrial grants totaling over $460 million. These projects involved an estimated capital expenditure on fixed assets and working capital of $1.8 billion. During 1976, alone, grants approved for new operations or expansions came to $69 million (about $124 million), which was associated with a total investment of $190 million ($342 million) and a job potential of 18,312. The IDA has reported that 1977 was a record-breaking year; total value of plant and equipment investment grew from $178 million ($320 million) in 1976 to $331 ($596 million) in 1977. Although most of the increase was from the U.S., that from European firms was up by 45% over the year. The U.S. total stock as of
1977 was $897 million, involving more than 200 manufacturing firms and representing about 75% of the total. The result has been that something upward of 50% of Irish manufacturing takes place in foreign-owned plants. Of course, Ireland has the advantage of being able to offer free access to the EEC market and relatively high quality and low cost labor.

Despite this success, Ireland's deficit on current account was expected to rise during 1978 from £200 million to £300 million ($360 to $540 million) as a result of deterioration in the visible trade balance, half of it being caused by oil imports. Meanwhile, the GDP was expected to grow by at least 6% through 1978, which is twice the EEC average. The rate of agricultural growth is considerably lower, 2%, and industrial production higher, 8 to 9%. Exports are targeted to rise over 11% in 1978 in real terms compared with 13% in 1977, with manufactured exports leading the way with a 15% gain. Unemployment is still undesirably high, roughly 10% (but down from 12% in 1977), and labor relations continue to cause concern. The inflation rate, however, was a respectable 6.2% in mid-1978.

A further measure of the Irish success has been the reverse of the "brain drain", which has been characteristic of Ireland for decades. During the 1950's and 1960's an average of 27,000 people emigrated from Ireland each year in search of work. From 1970 to 1976, there was a net inflow of 10,000 annually.

**TYPE 3 - ESSENTIALLY A SCREENING PROCESS.**

Unlike Types 1 and 2, a Type 3 policy requires evaluation of foreign investment and technology upon entry, not mere registration as in the Type 2 case. Hence, the policy rests more on restrictions
than on incentives, although many incentives may be offered to approved investment. Screening criteria often include foreign exchange impact (as in Egypt), local value-added (as in Mexico), a commitment to the nationalization of management (Kenya) and admission of local equity over time (Malaysia), skill transfer (Mexico), conformance with national plan (Kenya and Nigeria), non-competitiveness with local firms (Korea), use of a new technology (all), and amount of the investment (Nigeria). Type 3 countries tend to give preference to foreign investment in joint venture form. In regard to technology import, some countries (Mexico) are quite restrictive and severely limit royalties and fees. Incentives may be given approved investment projects on the basis of exports, employment, ownership, location and local value added. An example of a Type 3 policy is that of Egypt.

Example: EGYPT

In 1974 Egypt adopted a Type 3 approach to foreign investment. In doing so, it abandoned a Type 5 socialist joint-venture model which was basically hostile to foreign investment.

1. POLITICAL AND ECONOMIC OBJECTIVES.

The overall policy objective is sustained economic development under a relatively liberal economic-political regime. Persistent priority problems are inflation (officially estimated at 25%, but possibly 35 to 40%), subsistence-level incomes for the mass of people, a high level of unemployment and underemployment, and a massive external debt (something over $12 billion). Rapid population growth tends to sop up much of the economic gain realized. Agricultural production has been rising more slowly than the overall economic growth rate, which implies
increasing widening disparity between rural and urban areas. In general, income and wealth distribution seems to be worsening, possibly to a politically dangerous degree. Inasmuch as domestic savings are inadequate to fuel the planned development, such development must rest heavily on foreign aid, loans, and private investment. This need suggests a foreign policy orientation toward the sources of such capital, both Arab and non-Arab (that is, European, Japanese, and American). Possible mitigating factors include: discoveries of new oil fields in the Gulf of Suez area, increased income from tourism, gains in receipts from the Suez Canal and the SUMED pipeline, the inflow of remittances from Egyptian workers abroad, and recent rescheduling of foreign debt.

The National Plan (1976-1980) anticipates an annual growth in Gross Domestic Product from 8% in 1977 to 10% in 1980, with the industrial and mining growth rate being 17% and agriculture, but 3%. The accent in the industrial sector is on activating capacity idled by a lack of spare parts, upgrading some major production facilities, and encouraging projects that can rapidly generate exports. It is hoped that the country will reach an economic "take-off" position in 1980. President Sadat has embellished the Plan with his endorsement of heavy infrastructure investment towards "invading the desert" with cities. The Plan is a conscious reflection of earlier political decisions to introduce private market forces in the economy as a major transformation from the etatism of the Nasser era.

More specifically, the Plan lists industries and projects considered priorities for investors in Egypt: (1) replacement and renewal of industrial projects; (2) expanded exploitation of local resources (such as iron ore, phosphates, manganese, and salt); (3) self-sufficiency in local sugar and edible oil needs; (4) rehabilitation of spinning and weaving; (5) self-sufficiency in nitrogenous and phosphatic fertilizers; (6) expansion of aluminum and sponge iron
plants; (7) energy production (inclusive of such downstream activity as refining). These priorities are linked to the overall growth objectives, lower imports of semi-finished goods, and improvement in the quality control of local goods.

A secondary objective imbedded in Egyptian law is some degree of regional integration. The Arab Industrial Organization (a consortium of Egypt, Saudi Arabia, Qatar, and the United Arab Emirates) is headquartered in Cairo. Established in 1975, it is designed to develop an indigenous Arab armaments industry. The Organization has joint venture arrangements with several Western firms. Egypt is also a member of the League of Arab States and its major institutions, including the Arab Economic Unity Council. One of the Council's first steps was the creation of the Arab Common Market (ACM), which currently consists of Egypt, Jordan, Syria, Iraq and Libya. Members of the ACM have agreed in principle to remove all customs duties on agricultural and natural resource commodities as well as manufactured products among themselves, creating in theory a free-trade area. There are, however, significant quantitative restrictions on trade in manufactured goods effected through bilateral trade agreements which set target ceilings on the quantity of goods that two member states will exchange. The next step toward Arab economic unity is to be the creation of a customs union during 1978-1981, which would eliminate all trade barriers among an expanded membership (Sudan and the People's Republic of Yemen), and establish a common external tariff. Events in the latter part of 1978, however, are likely to delay matters.

2. SCOPE OF GOVERNMENT CONTROL.

All foreign investment projects and license and technical assistance contracts must be approved by the Government.
3. ADMINISTRATIVE DEVICES.

A. Foreign Exchange Controls and Incentives. Four exchange rates are used: an official rate*; a parallel market rate primarily for the private sector which is determined weekly by supply and demand, but which is subject to Central Bank intervention; own exchange market rate, which allows individuals or companies possessing foreign exchange to import foreign goods from the list of approved "parallel market" goods without converting their currency; and the Port Said rate, which is used in the free zone (see below) and is a legal version of the free currency market. Foreigners may supply commodities directly under the own exchange market system, deposit the sale proceeds in a special convertible Egyptian pound account, which may be used subsequently to finance tourism in Egypt or to buy nontraditional Egyptian exports.

The initial version of the 1974 Law on Foreign Investment specified that any repatriation of earnings or capital be made at the official rate prevailing at the time of the transfer. A 1977 amendment provided that such transfer should be made "at the highest rate prevailing and declared for free foreign currency by the competent Egyptian authorities (that is, at the parallel market rate), provided a revaluation of assets has taken place."

Transactions carried out in a free zone or between such zones and other countries are not subject to exchange control.

In general, approved foreign investment enjoys the right to partial exemption from exchange control. Such projects have the right to maintain a foreign currency account, which may be credited

* According to a press account on December 5, 1978, Egypt will abandon the "official" rate in January 1979, thereby leaving only the "parallel" or "incentive" rate for most transactions.
the amount of any capital (equity or debt) originating in foreign currencies, funds purchased from local banks at the highest rate prevailing, the proceeds from sales to the local market in foreign currency. This account may be used without special authorization for the payment of imports of commodities and investment goods, associated invisible expenses, interest and principal on foreign currency loans, and for the purchase of local currency. Foreign firms are expected to be self-sufficient in foreign currency.

Industries considered "priority" or basic to the economy may remit profits in full even if no exports are planned or realized. On the other hand, there is a de facto limit (approximately the level of that exchange the Government would have had to allocate for imports in the absence of local production). The foreign exchange earning proviso which requires foreign exchange cover for profit remittances applies in nonbasic industries although little foreign investment in Egypt is in this category. Even so, such firms are permitted to remit up to 12% of registered capital.

Five years after the original investment, capital may be repatriated in five annual installments at the parallel exchange rate at the time of repatriation. Repatriation is also permitted if the Commission is satisfied that a project cannot be implemented or continued for reasons beyond the investor's control.

Transactions between companies which operate inside a Free Zone and their overseas clients must be done in foreign currencies. Transactions with residents of Egypt are to be made at the official rate of exchange. Free Zone companies use two different accounts: a foreign exchange account which takes in funds from overseas; and (2) a "working account" in Egyptian currency which is fixed at the level of two-months' working capital and is renewed from the foreign currency account at the official rate of exchange. All local cash obligations
are drawn from the working account, the most important of which are dues paid to the GAIFZ, expenses for local services and wages.

B. Restrictions. Under previous regimes, a number of areas were reserved for state control, specifically, transportation and other public services, most heavy and medium industries, oil and mining, a large part of the import and export trade, a substantial portion of domestic wholesale and retail trade, and most banking and insurance business. Subsequently, some of these sectors were open to private ownership (banking, transportation and commercial shipping), and in September, 1975, President Sadat slowed the growth of the public sector by dissolving the holding companies, the so-called General Organizations.

By a 1974 law, authority to approve all incoming foreign investment proposals and reinvestments was bestowed upon the Board of Directors of the General Authority for Investment and Free Zones (GAIFZ). Intangible assets (patents and trademarks) and "free currency" spent on preliminary studies, research and incorporation and assumed by the investor may be capitalized. Foreign investment in Egypt is to be for the purpose of "realizing the objectives or economic and social development within the framework of the State's general policy and national plan, provided that the investment is made in projects in need of international expertise in the sphere of modern development or in projects requiring foreign capital." Such projects, contained in lists prepared by the Council of Ministers, are to be in industry, mining, tourism, transportation, land development (under long-term tenancy not exceeding 50 years), housing and urban development, investment companies and banks, banks engaged in local currency transactions provided they are 50% Egyptian-owned, construction activities in regions outside the agricultural area and the perimeters of existing cities, construction contracting activities undertaken by joint stock companies which are at least 50% Egyptian owned, and technical consulting activities related to any of the previously-listed areas. Special priority is given to those projects designed to generate exports, encourage tourism, or reduce the need to import basic commodities, as well as to projects requiring advanced technical expertise or which make use of patents or trademarks of
worldwide reputation. Projects designed to produce principally for the local market may be approved, although only as joint ventures with Egyptians. It is possible, nonetheless, for a foreign investor to retain 100% with little or no pressure to acquire a local partner. Investment in kind is severely restricted, including the capitalization of used equipment.

Approved projects are not subject to the usual requirements related to the election of labor representatives to boards of directors of joint stock companies. The statutes of the company must show, however, the method to be applied for labor participation in management. Nor are they required to provide a specified percentage of net profits to be distributed annually to employees.*

No Government employee involved in the licensing of an enterprise, or supervising its activity during the year prior to termination of his public service, may undertake any private activity - in respect to such enterprise.

Neither imports associated with the operation of a project, nor exports, are subject to licensing in the case of approved enterprises.

There are no regulations governing manufacturing under license in Egypt. Terms and conditions are negotiated in each case with the Ministry by the two parties. Overseas firms providing equipment and knowhow are normally paid a royalty between 2% and 5% on production over a period of five to ten years.

Egyptian citizens must constitute 75% of total salaried employees and receive 65% of the total salary payroll. Of wage earners, 90% must be Egyptian and receive 80% of the workers' payroll. Special permission

* Egyptian-owned firms must pay 10% of net distributed profit up to a maximum of E£75 (about $30) per employee. In addition, 15% of net profits are paid into various funds for improved working conditions and the construction of recreational facilities. Approved foreign enterprises are exempt from these requirements.
must be obtained for any employment of foreigners. These rules are not, however, applicable in the free zones, although a foreigner is still required to have permission of the zone's chairman of the board.

Foreign-owned firms are exempt from the requirement that they share 2.5% of their profits with the work force or purchase Government bonds with 5% of their profits. Finally, interest due on foreign loans to approved investors is tax-exempt.

Projects established in a free zone are exempted from Egyptian tax altogether, and expatriate personnel employed in such a zone are exempt from income tax. Since 1977, foreigners employed in any approved project, wherever located, are exempt from tax on earned income.

Investors may negotiate waivers of import duties and fees in regard to equipment and materials needed for a particular enterprise. These goods, however, may not be sold locally for five years.

Investments made in activities located within a free zone enjoy extended benefits as compared to approved investment outside a zone. It is also possible to set up a private free zone, in which case the firm itself must bear the administrative and insurance costs. It should be noted that free zones are under a disadvantage in that they are considered legally to be outside the Arab Economic Community and, hence, firms located in a zone do not qualify for the regional tariff concessions enjoyed by non-zone firms.

C. Guaranties. The 1974 law declares that approved investment projects may not be nationalized or expropriated except by judicial procedure. Investment disputes relative to the implementation of the law may be settled either in a manner to be agreed upon with the investor, or within the framework of the Convention for the Settlement of Investment Disputes, to which Egypt has adhered since 1971. Disputes may also be settled through local arbitration. The 1971 and 1974 investment laws
contain a guarantee against inconvertibility. This is reinforced by bilateral agreements with Switzerland, the Federal Republic of Germany, the U.S., France and the United Kingdom. OPIC guarantees are available for U.S. investment.

D. Credit Incentives/Disincentives. None reported.

E. Tax Incentives/Disincentives. Tax incentives are given automatically when an investment project is approved by the GAIFZ. Profits of new approved foreign-owned companies are exempted from profit taxes for five years, subject to extension for another three years upon approval of GAIFZ and the Council of Ministers. The 1977 law provides for extensions up to ten years for projects involving reconstruction, establishment of new cities and land reclamation. Even after this tax holiday expires, distributed profits are exempt from the tax on business income up to a maximum of 5% of the original amount of the taxpayer's share in the invested capital. Reinvested profits enjoy the same exemption as original capital. Distributed profits are exempt from the withholding tax on income from movable assets and related taxes for five years, extendable to eight. Profit tax exemptions are presumably not available if the profits so exempted will be taxed in another country (which would be the case for any country taxing world-wide earnings of its corporations and not recognizing the tax-sparing principle, as the U.S.).

Projects set up in a free zone are subject only to a 1% tax on the value of imports or exports. Otherwise, all transactions are free of tax unless they involve sale into Egypt, in which case normal duties are paid (subject to a reduction to 50% for local material content up to 40%).

F. Market Protection. Once a product is manufactured within the country, imports of competitive goods may be banned.
G. **Subsidies.** Investors may request the assistance of GAIFZ in undertaking feasibility studies or other surveys or in arranging special training programs for workers.

4. **EVALUATION.**

Although no official figures are published, foreign investment has picked up sharply in recent years, albeit from a low base. World Bank sources report that the private foreign investment flow rose from $7 million in 1974 to some $20 million in 1975 and $50 million in 1976. Other sources indicate a current yearly level $200 to $300 million. The Government hopes that the flow will swell to $1 billion in the near future, which seems unduly optimistic. It is known that since the Investment Law took effect in 1974, something like 605 projects have been approved for a total value of $3 billion, including $2 billion in foreign currency. But only a small number are actually under construction.

It may be reassuring that in August 1978 the International Monetary Fund negotiated with Egypt a three-year standby credit of $720 million. Also during the year, Egypt's $12 billion in foreign debts and investments during the first year of the 1978-82 development plan were rescheduled. The U.S. 1979 AID program in Egypt will total $550 million.

A major deterrent to foreign investment in Egypt lies in the foreign exchange control system. Capital investment denominated in a foreign currency is made at the official rate, but the repatriation of capital must be made at the prevailing or "parallel market rate." In that the official rate tends to overvalue the Egyptian pound in reference to key foreign currencies, at least as measured by the clearing rate in a relatively free market (the "parallel" rate), the investor loses if and when he repatriates his capital. As of
mid-1978, it was not clear what rate would be used for dividends. However, if the adoption of a single exchange rate, as announced in December 1978, is effective, this problem should be eliminated.

The requirement that new foreign investment, other than that deemed to be "basic," must cover its own foreign currency costs has the effect of excluding non-exporting enterprises, in that relatively few of the investments approved over the past two years have been identified as "basic."

Egypt's economy remains predominantly Government-owned and operated, something over 50%. President Sadat, however, has declared an intent to change over gradually to a mixed economy. There are plans to open up Government-owned firms to private investment, although adverse public opinion seems to have slowed this development.

It would appear that high inflation and low incomes have embittered a large percentage of the population. Opposition to economic liberalization is reportedly strong, and the less-privileged Egyptians resent the new middle class which seems to be the principal benefactor of the new "open door" policy, which has produced a flood of luxury consumer goods. Early in 1977, President Sadat was forced to reinstate subsidies on food and other goods, despite recommendations by the IMF and others that Egypt end the subsidies and implement an austerity program.

Despite the difficult debt situation and operating conditions, investment activity has been on the rise. Some Government-owned enterprises are moving into joint ventures with local and foreign investors. An example is the Government-owned El Nasr Company's four divisions producing vehicles which are establishing ventures with foreign firms. As of mid-1978, the company had signed an accord with Fiat and talks were under way with Massey-Ferguson, Pullman, and the Ford Motor Company.

Foreign firms entering Egypt have reported bureaucratic inflexibility, delay in the review of project applications due to lack of technical expertise, and inconsistency in the application of the law. An example
of the latter concerned the General Authority for Foreign Investment and Free Zones, which had been informing foreign investors that certain equipment could enter the country duty free, and the Customs Department and the Trade and Supply Ministry, which insisted that it could not. A review board was to have been set up to provide potential foreign investors with a mechanism by which projects could be agreed upon more rapidly, but because of interministerial rivalries, it does not seem to have materialized. It is reported that a recent study identified 180 different steps a foreign investor was required to take in order to make operational an Egyptian enterprise. Many have reported a significant gap between the goals, capabilities and degrees of commitment of the Egyptian leadership and those employed at lower levels of government.

**TYPE 4 - SELECTED, NEGOTIATED ENTRY**

In this case, entry is characterized by an entry agreement or contract (although rarely called such) in which conditions under which the foreign investor will operate are explicitly spelled out. Specific, quantifiable criteria may or may not be employed. (The Philippines is an example of the former.) Entry agreements most commonly specify that foreign ownership is limited to a specific time, but that so long as the foreign investor lives up to his commitments, foreign ownership during that period will not be attacked (Indonesia, Peru). A variety of incentives may be given or withheld, depending upon perceived costs and benefits associated with the project. For those projects with low cost/benefit ratios more liberal foreign ownership and managerial control provision may be recognized (Philippines), more liberal employment provisions relating to expatriates granted (Sri Lanka), more liberal treatment in respect to the repatriation of earnings given (Sri Lanka), and recourse to external arbitration permitted (Indonesia, Sri Lanka). The classic example of a Type 4 policy is that of the Philippines.
The Philippines perhaps maintains one of the world's most complex set of rules and regulations relative to foreign investment. Essentially, a foreign investor must negotiate an entry agreement, which places Philippine policy in the type 4 category.

1. **POLITICAL AND ECONOMIC OBJECTIVES.**

High on the list of objectives of the regime of President Ferdinand E. Marcos is the maintenance of non-violent relations with the Moslem minority in the southern islands and the general enforcement of law and order. Also high on the list is continued economic growth, a more equitable distribution of income, elimination of corruption, and the maintenance of a free enterprise system. The Philippine Government has been acting to promote regional integration within the framework of ASEAN. The former pro-U.S., anti-socialist orientation of Philippine foreign policy has shifted more recently toward neutrality, including diplomatic recognition of the People's Republic of China in 1975. On a more specific level, the Government has for some years been trying to make Manila a regional headquarters site for international companies. In 1976-1977, it also made moves in the direction of making Manila more of a regional banking center and a transshipping point.

2. **SCOPE OF GOVERNMENT CONTROL.**

Approval and registration by the Board of Investments is required for all investment containing 30% or more foreign equity. Similarly, any investor who wants to take advantage of investment incentives must have the project approved and registered. New industrial projects are also subject to review by the National Economic Development Authority.
if the investor wants to lease government land, obtain a tax exemption on imported equipment or borrow from Government financial institutions. Most areas of investment are reserved for Philippine citizens or corporations at least 60%-owned by Philippine citizens. The Central Bank must approve all license and technical assistance contracts under which royalties and fees are to be paid to foreigners. The Board of Investment requires registration of all technology transfer agreements involving "preferred industries" (see below). The Patent Office supervises licensing agreements covering patents, trademarks, and tradenames registered with it.

3. **ADMINISTRATIVE DEVICES.**

   A. **Foreign Exchange Controls and Incentives.** Remittance of profit and dividends and remittances of royalties, fees, and rentals up to certain limits may be made without prior authorization of the Central Bank, provided they are not financed from domestic credit. Otherwise, no person may take any foreign currency or other foreign exchange out of the Philippines without prior approval. Under an "export deduction" scheme, export-oriented industries are allowed, subject to Central Bank approval, to use a part of their export proceeds for the repayment of loans obtained for imports of machinery, raw materials, and other requirements. All inward and outbound capital movements, with the exception of certain banking operations and international trade financing, are subject to Central Bank approval. When applications for new inward foreign investments, as well as new foreign borrowings are reviewed, preference is given to projects approved by the Board of Investments, export-oriented industries and other industries not utilizing domestic credit sources. In general, all foreign exchanges proceeds must be surrendered.
B. Restrictions. All petroleum exploration and related activities have been reserved for the Government, but foreign companies are permitted to enter into service contracts for drilling. Foreign concession-owners were given until a specific date (mid-1976) to convert their concession rights to service contracts. Such contracts call for a 65% production share for the Government. Also reserved for the Government are the manufacture of munitions and the development of hydro-electric and nuclear power. Retail trade, rural banking and the mass media are entirely closed to foreign capital. However, four types of sales are not considered retail transactions: (1) sales by manufacturers or processors to industrial and commercial consumers who use the products to render services to the general public and/or to produce goods for sale to the public; (2) sales by hotel owners or hotel keepers operating restaurants if the restaurant is directly connected with the hotel business; (3) sales by manufacturers or processors to the general public provided the capital of the company does not exceed P5,000 ($680); and (4) sales by farmers of their farm products. Although previously closed to aliens, the rice, corn, and fishing industries are now open.

With four exceptions, foreign banks have been barred from establishing local branches. They have, however, been permitted to acquire equity up to 40% in Filipino banks and to open offshore banking units. These latter refer to facilities to service the needs of investors in the Philippines in foreign currencies. Up to 49% foreign ownership is permitted in investment houses.

The Government is authorized to regulate or prohibit private monopolies and unfair competition or combinations in restraint of trade.

The National Price Control Commission is empowered to fix maximum prices (not to exceed production costs, plus a 25% markup for manufacturer, wholesaler and retailer combined; 20% for imports). Controls have been extended to nearly all consumer goods, with the emphasis on
controlling the prices of basic and essential items used by low-income families.

License and technical assistance contracts are limited to a maximum period of five years. The maximum royalty is limited to 5% of wholesale price. Contracts may not restrict the export territory of the Philippine licensee, or may they stipulate that exports must be channeled through the licensor as exclusive distributor.

Aliens may not participate in the management of firms in industries limited to wholly Filipino-owned or at least 60% Filipino-owned companies. Alien directors, however, may be represented on the board of directors to the extent of their personal or representative ownership of such companies. Technical personnel are exempt. Nor does the restriction apply to firms registered with the Board of Investments for five years from date of registration. Among such companies, "non-pioneer" firms (see below), including those with non-pioneer export status and those operating within export-processing zones, can employ aliens in supervisory, technical or advisory positions only to 5% of their total personnel in each category. This limitation does not apply to "pioneer" firms (see below). After five years, all firms registered with the Board of Investments must obtain approval of the Secretary of Justice to retain aliens in top management positions.

Prior government approval is required for all investments with 30% or more foreign equity. There is no initial limit on foreign equity for firms operating in a "preferred pioneer industry", which is one designated as such in the Investment Priorities Plan. However, the share of foreign ownership must be reduced to 40% within 30 to 40 years and the sale of stock begun within 15 to 25 years. The longer time limits relate to those pioneer enterprises exporting at least 70% of their production. Also, companies operating in the export processing zone may be 100% foreign-owned. "Preferred non-pioneer industry," which is listed in the Investment Priorities Plan, must be at least 60% Filipino-owned. However, up to 100% foreign ownership may be permitted if a firm is in a preferred industry in which the "measured capacity" has not been filled within three years.
of its declaration as a preferred area. Measured capacity is the Board of Investment's estimate of desirable production. On the other hand, the Board may place more restrictive foreign-ownership restraints on enterprises operating in sectors deemed to be overcrowded. In such cases, foreign equity is usually limited to 30%.

Enterprises operating in industries listed in the Export Priorities Plan and exporting at least 70% of their output may be 100% foreign-owned. Other firms in sectors so listed must be at least 60% Filipino-owned. If not in such a listed sector, but with annual export sales exceeding $5 million, an enterprise must be at least 70% Filipino owned. Additionally, enterprises in activities listed on the Tourism Priorities Plan and which have minimum export sales of P5 million (roughly $675,000) may be 100% foreign-owned. Others must be at least 60% Filipino-owned.

These various categories of enterprises (nonpioneer preferred, pioneer preferred, export priority, tourism priority) may be given a variety of incentives as listed in the appropriate sections below.

In general, a Board of Investments' approval is conditioned upon the sector in which the proposed sector will operate, the ownership of the enterprise, newness of the technology to be used, and anticipated exports. Beyond that, the projected enterprise is subjected to economic evaluation. Twelve measures are used:

1. Foreign Exchange Benefit-Cost Ratio, which is the ratio of gross foreign exchange earnings or savings to total foreign exchange flows.

2. Foreign Exchange Benefit-Import Raws Materials Ratio, which is the ratio of gross foreign exchange earnings and savings to the imported raw materials cost.

3. Discounted Rate of Return on Foreign Exchange Investment, which is the present value of the discounted flow of expected net foreign exchange flows.
(4) Labor Intensity, which is formulated first as the ratio of imported capital assets per man-year of direct employment generated by a project in each year of full operation. The maximum ratio is considered to be $4,000 per man-hour at the time of project evaluation. Exceptions are made, specifically:

(a) those projects which are entirely export-oriented,
(b) those projects with sufficient export potential so as to comply with the condition that they generate in the first five years of operation new export revenues in an amount aggregating at least the difference between the total foreign exchange capital cost of the project and the amount resulting from multiplying actual project employment by $4,000,
(c) projects included in sectoral programs or with justifiably strong reasons for being included among the exceptions.

(5) Amount of Capital (Fixed Assets, Excluding Land) Per Unit of Labor, which is the ratio of such assets to the number of workers.

(6) Amount of Capital (Fixed Assets Excluding Land) Per Labor Cost, which is the ratio of such assets to total payroll.

(7) Value Added Coefficient, which is the ratio of value of output, less raw materials, utilities and supplies, to value of output, all in domestic prices.

(8) The same, but denominated in world prices.

(9) Capital-Output Ratio, which is the ratio of fixed assets excluding land to the value of output less raw materials, utilities and supplies.

(10) Usage of Indigenous Raw Materials, which is the ratio of the cost of local raw materials to the total of raw materials purchased.

(11) Dispersion Index, which is a measure of backward linkages, which is the sum of the increase in outputs of all industries supplying the project.

(12) Sensitivity Index, which is a measure of forward linkages, which is the sum of the increase in outputs of all industries supplied by the project.

All enterprises engaged in the ownership of real estate or public utilities or in the development of natural resources (mining, agriculture, forestry, oil exploration) must be at least 60% Filipino-owned.
In many cases, the foreign equity is in fact limited to 30%. The restrictions on the foreign-ownership of real estate means that industrial enterprises in which foreign ownership exceeds 40% must either lease their sites from 60% Filipino-owned firms or themselves sell at least 60% of their equity to individual Filipinos or 60% Filipino-owned firms.

The general rules for local content are flexible, but there is a minimum local-content specified for each industry, depending upon its net contribution to the Philippine economy and availability of local labor. Participants in the Government's car manufacturing program must achieve a certain percentage of local content over a specified period of time. Participating firms were required to achieve 15% local content by end-1973, 20% by end-1974, and 37.5% by end-1975, and 62% by end-1976. In fact, the requirement has been frozen at 50%, which level has been maintained to mid-1978. Similar requirements have been imposed in the truck and motorcycle manufacturing programs, and a somewhat similar program is being set up in the electronics sector.

A rice subsidy program requires all companies with more than 500 employees to acquire rice for their staff through direct import or cultivation.

C. Guaranties. Enterprises qualifying as preferred investment (pioneer and non-pioneer), export priorities, and tourist priorities, and those operating in the export-processing zone, enjoy Government-backed guaranties of the convertibility of earnings and capital and against expropriation. Similar guaranties are given to enterprises which are at least 70% Filipino-owned and officially registered and to other enterprises with less than 70% Filipino ownership when deemed legal and not inconsistent with the Investment Priorities Plan and which have been duly registered.

The Philippines is a member of ICSID, which may mean that alleged breach of a BOI commitment to a private foreign investor would be subject to arbitration in that forum.
Export insurance, which covers both political risk and specified commercial risk, is available from the Philippines Export Credit Insurance and Guarantee Corporation.

D. Credit Incentives/Disincentives. Preferred industries are given favored treatment by Government financial institutions. Concessionary export credit is available under some conditions. Local borrowing by firms with less than 60% local-ownership is restricted. For this purpose firms are grouped into three categories:

Group A - firms registered as preferred industries or covered by the Export and Priorities Plans, those registered in export processing zones, those with Central Bank certification as export-oriented, those in industries deemed to be vital. Such firms are not permitted to borrow locally if such borrowing raises their debt/equity ratio above 60/40.

Group B - foreign firms engaged in manufacturing not covered by Group A. These must keep their debt/equity ratio below 55/45 to borrow locally.

Group C - foreign firms engaged in nonmanufacturing activities (other than export-oriented firms) must keep their ratio to 50/50 to borrow locally.

Firms already operating in the Philippines were given three years to meet these ceilings according to a specified schedule of reduction. Exceptions may be granted by the Central Bank on a case-by-case basis.

E. Tax Incentives/Disincentives. Enterprises qualifying for preferred status may opt to accelerate depreciation of fixed assets either at a rate up to twice the normal rate (if expected life is ten years or less) or over a period of between five years and the expected life of the asset (if the latter is more than ten years). They may
also carry losses forward up to six years. In addition, they may obtain tax credits for equipment purchased locally; receive an exemption from, or reduction of, tariffs (also of the sales tax up to seven years on imports of capital equipment not available locally), and deduct from taxable income such preoperating expenses as preinvestment studies, startup costs and initial recruitment and training expenses over a period of ten years from the start of operations. Subject to the approval of the Board of Investments, they may also be authorized to deduct from taxable income a percentage of the undistributed profit reinvested in productive facilities during the year such investment is made. This deduction ranges from 25 to 50% for nonpioneer preferred projects to 50 to 100% for pioneer preferred projects. Pioneer enterprises can also usually obtain exemptions from all national taxes, except the income tax, as follows: 100% for the first five years, 75% for years six through eight, 50% for years nine and ten, 20% for year eleven and twelve, and 10% for years thirteen through fifteen. Finally, generous tax incentives are granted to new export-oriented companies, with special deductions for expenses incurred in exporting (promotion, shipping and research and development).

Expatriate employees of headquarters' operations in Manila are accorded favorable tax treatment.

Exemptions from tariffs are available for enterprises qualifying under the Export and Tourism Priorities Plans.

Some products are subject to a concessional rate of sales tax if they meet specified percentages of local content. Exported goods with 70% local content qualify for this concession.

Incentives have been introduced to attract more equity participation from the public, specifically: indefinite suspension of the capital gains tax on sales of shares, establishment of "dollar boards" to list Philippine shares in U.S. dollars for the purchase by nonresidents, and development of offshore banking facilities.
F. **Market Protection.** Tariff protection is generally given to enterprises qualifying for pioneer status. Preferred industries, both pioneer and nonpioneer are assured of protection from Government competition.

G. **Subsidies.** The Government is prepared to subsidize firms which find themselves net losers under the program of controlling prices of goods bought by the poor.

4. **EVALUATION.**

Gross Domestic Product continues to rise. Its growth was reportedly 6.3% for 1977, up from 6.1% in 1976. Agricultural output was slightly above the aggregate growth rate; manufacturing slightly, below. Mining led the way with a 10% growth rate. Foreign investment in 1977 was sluggish, with only $46 million recorded, which was the lowest of any year since 1972. Many feel that continuing changes in the ground rules applicable to investment are undermining investor confidence, both foreign and domestic.

Between 1968 and early 1977, total investment by firms with some foreign equity and carrying Board of Investments approval totalled just under $1 billion, of which 54% was foreign. Accumulated foreign investment actually made stood at $560 million in 1976, of which the $220 million was of U.S. origin and $150 million of Japanese. The number of joint ventures between Japanese and Filipino investors totalled 385, about half of which have been created since 1974. Meanwhile, foreign reserves fell, despite the fact that export earnings in 1977 climbed to a record high of $44 million, which represented a 57% improvement over 1976. Impressive export growth has continued into 1978, but the foreign debt total climbed to a record $7.1 billion by mid-1978.
Despite this mixed record, there is evidence that a number of Philippine programs had enjoyed some measure of success. The ASEAN Preferential Trading Agreement was signed in 1977, which covered tariff reductions, liberalization of non-tariff barriers, long-term commodity-supply contracts, trade financing at preferential interest rates, and preferential margins in international tenders for procurements by government agencies. Tariff protection was granted to goods and services produced under ASEAN industrial complementation projects and to certain basic commodities.

Some 270 firms were participating in the corporate farm program under the rice subsidy provision, and 37 foreign firms have joined a program to cultivate their own rice.

Fourteen firms have participated in the Progressive Truck Manufacturing Program and five in the Progressive Car Manufacturing Program. An unspecified number of companies have indicated intent to participate in the Progressive Electronics Manufacturing Program. All involve commitment to a progressive schedule of developing local content.

In response to the restriction on the ownership of real estate to 60%-owned Filipino-owned companies, a number of foreign firms either sold the land on which their plants stood to employee pension funds (with a lease-back arrangement), donated the land to a recognized charitable organization and leased it back, or tied up with the Government-controlled National Development Corporation and took a 40% minority position in the resulting land-holding venture.

In contrast, the Government's program of "socialized pricing" (price control on goods bought by the poor) has resulted in much confusion. A number of stores in Manila have been closed for pricing offenses.
Several problems are inherent in the criteria ratios employed by the Board of Investments. Insofar as is known no threshold values, other than the $4,000 per man-year figure for imported capital investment, have been set. What priority is given among these twelve measures? Would exceptional performance in terms of any one make up for failure to meet a threshold value for one or more of the others? If so, what are the tradeoffs? In any event, the ratios are calculated on the basis of estimates of futures performance. What happens when an enterprise does not perform as expected? Are the incentives then withdrawn? These questions do not seem to be answered. In any event, the very complexity of the entire system invites criticism. Many observers suspect that the overall effect of Board decisions is biased in the direction of capital intensity, not employment.

Among the other programs, both those designed to attract regional headquarters of international firms and to promote export-oriented industry into the export processing zone seem to have been moderately successful on the basis of press reports. Forty-six manufacturing firms were established in the export processing zone by mid-1978. Their aggregate investment was $200 million and aggregate employment, in excess of 21,000. Included were a number of wholly foreign-owned ventures.

The three lists of priorities announced by the Government in 1977 - the Investment Priorities Plan, the Export Priorities Plan and the Public Utilities Priorities Plan (not discussed here) - seemed to indicate shifts in investment policies away from a project-by-project approach to a program approach. Also, the financing of the plans suggested a more important role for the private sector than in the recent past, but there were clear signs that the Government wants to see foreign investors play a somewhat smaller role in new investment. It would, however, continue to be encouraged in the capital-intensive and high-technology areas. During the 1982-1987
period the gap between growth in Government and private investment is expected to narrow.

As part of the program to placate the Moslem dissidents concentrated in the southern islands, a major development effort is to be concentrated in Mindanao. According to the five-year plan (1978-1982), economic growth of Mindanao is to outpace that for the rest of the country, with northern Mindanao becoming a major industrial region.

In general, companies already manufacturing in the Philippines can be expected to be encouraged to move away from import-substituting to export-promoting activities. Labor-intensive industries are to be encouraged under the new plan, which is a tacit admission of the failure of previous plans to achieve employment targets.

TYPE 5 - THE SOCIALIST MODEL -

In this case, direct foreign investment is permitted only in the form of a contractual joint venture established for a specific purpose and for a specified length of time. In all known instances to date, the foreign investor has been limited to a minority equity position, although he may be given a veto power over decisions taken by the joint business board of certain key matters. Jugoslavia pioneered in this type of investment, but has been followed in recent years by Hungary, Poland, and Roumania. And late in 1978, the People's Republic of China announced its willingness to accept foreign capital on a similar basis. A significant difference among these countries lies in the degree of autonomy enjoyed by the individual enterprises in negotiating joint venture contracts with foreign interests. The Jugoslav firms seem to have the greatest freedom in this respect. Another important difference is to the extent to which these enterprises are self or employee-managed. Again, the Jugoslav enterprise probably represents the greatest degree of self-management, although it is known that the PRC has been studying the Jugoslav
model at first hand and professes to be much interested in introducing a similar structure in China. In all cases, of course, the foreign investment must be consistent with national economic plans and national laws, although considerable latitude is given in the Yugoslav case to the negotiating parties. In all situations, however, the final contract is subject to governmental approval.

Example: JUGOSLAVIA

Jugoslavia represents the socialist model of foreign investment promotion, the first to allow direct foreign investment based on foreign minority interest (Type 5). As a result it leads the socialist countries, both in joint equity ventures (94% of the total located in Eastern Europe) and in nonequity cooperation agreements (40% of the total located in Eastern Europe and the USSR).

1. POLITICAL AND ECONOMIC OBJECTIVES.

Since 1950, and at a quickening pace since the mid-1960's, Jugoslavia has evolved toward a goal of "market socialism" involving social ownership of the means of production and worker self-management in enterprise decision-making. It stands alone as a socialist non-aligned nation, separated from the CMEA* group linking Eastern Europe and the Soviet Union, and from Western Europe. Therefore, its more liberal policies vis-à-vis Western business reflect its desire to build a viable economy with minimum dependence upon the CMEA countries.

The Federal Government outlines general development goals in Five-Year Plans and relies on the League of Communists in the six republics

* Council for Mutual Economic Assistance. Jugoslavia does participate in some CMEA committees.
and two autonomous regions to coordinate specific targets in monetary, foreign trade and exchange policies, policies to aid less developed areas, taxation, social plans, and the federal budget. Various inter-republic agreements and social accords with specific sectors of industry are concluded to implement the development plans. Government intervention is generally selective and indirect, while direct policies promote investment in priority sectors, regulate economic activity in the private sector, and control foreign exchange.

Specific economic problems in this decentralized system are labor and capital mobility,* low capacity utilization of industry, inefficient resource allocation, shortage of skilled labor, unemployment, inflation, and trade deficits. A major problem which encompasses all of the above is marked regional disparities in levels of economic development, magnified by ethnic or nationality conflicts.

The foreign investment program is part of the general policy of economic expansion, and must be viewed within the context of Jugoslavia's need to control the location of foreign projects, to preserve the socialist system of worker self-management, and to offer sufficient incentives to attract investors. The federal or republic governments approve all cooperation agreements, while the National Banking system and Foreign Trade Secretariat apparatus enforce hard currency regulations. Non-equity cooperation agreements (exchange of capital or technology for product) have been concluded since the mid-60's, while joint ventures were initiated in 1967.

Three major goals of these cooperation agreements are: (1) to improve the efficiency of Jugoslav enterprises by incorporating new technology, management and marketing techniques, rather than to attract outside capital, (2) to offer the prospect of longer run domestic

*To promote capital mobility, firms and individuals have been authorized to buy and sell shares in some of the major enterprises.
employment, and (3) to act as potential instruments of regional development policies. In general cooperation agreements, emphasis has been placed on production specialization and mutual deliveries of industrial components, the largest number being in engineering or machinery (81%), including nonelectrical machinery, machine tools, electronics and electrical equipment.

2. SCOPE OF GOVERNMENT CONTROL.

While joint venture and non-equity cooperation agreements are negotiated directly by the prospective foreign partner and a Yugoslav enterprise, all are subject to government approval. Legality under Yugoslav law and the equity of the terms are the principal screening criteria.

3. ADMINISTRATIVE DEVICES.

A. Foreign Exchange Controls or Incentives. All foreign currency transactions must be carried out through an authorized bank. However, commercial exports and imports may be affected by all economic organizations registered for this purpose. The exporting enterprise has the right to deposit foreign currency earnings to its own credit and to use them, subject to relevant regulations, for payments for imports of either goods or services. Part of the export proceeds, a so-called "retention quota," remains at the free disposal of the exporter. The permitted retention rate, which is used as a sectoral incentive, normally varies from 20% to 45%, but may go as high as 100% for foreign exchange earnings of Yugoslav enterprises located abroad and to those operating under long-term cooperation agreements with foreign companies. These latter may, in any case, import up to the value of production resulting from such cooperation.

Repatriation of profits by foreign investors in joint ventures has caused the most difficulty. In order to expand hard currency exports, repatriation of profits and invested capital have been limited by the
provision that it be financed by convertible currency earnings of the enterprise. Until 1978, a foreign partner could transfer up to 50% of total enterprise earnings realized in the convertible currency. Whereas a 1973 law left it open to the partners to negotiate profit shares, new rules state specifically that the foreign partner's profits share is to be determined by the proportionate value of its investment. New 1978 legislation aims specifically at helping the poorer regions of Jugoslavia. A ceiling on transferred profit is to be computed by the partners based on past enterprise income and industry averages. Currently, in the most developed republics, there is a 50% limitation on the transfer of total foreign exchange earned from exports. To stimulate investment in the less developed regions, the entire portion of after-tax profit contractually owed to the foreign partner may be transferred abroad without hard currency limitations. In such case there is no stipulation that the joint venture must generate enough hard currency income through exports to cover this amount. Domestically-oriented joint ventures still may face some problems, since they must buy hard currency on the Belgrade foreign market with which to transfer profits in convertible currency. However, the 1978 law specifies that a foreign partner may receive profit transfers in product, which is particularly attractive for projects in agriculture, forestry, or mineral extraction.

B. Restrictions. Jugoslavia has continued to broaden the area in which foreign investment is allowed. As of 1978 all branches of the economy were open except insurance, certain internal communications, and services. However, foreign firms could invest in domestic transport, city services, banking, and local retail organizations.

Direct foreign investment is normally limited to minority joint venture participation. Such ventures must be established within existing Jugoslav enterprises (Basic Organizations of Associated Labor, or
BOALS) and are termed "joint investment projects." They are subject to domestic Jugoslav law and must be approved by the Federal Committee of Energy and Industry after consultation with republic and provincial authorities, the Federal Institute of Economic Planning, and the Jugoslav Chamber of Economy. While generally limited to 49% equity, a foreign interest may exceed that limit if the Jugoslav Federal Assembly so approves. While equipment and capitalized knowhow were previously restricted to a percentage of the total investment so as to obtain more hard currency, the only items now excluded are those already produced in required quantity and quality in Jugoslavia.

It is important to note that Jugoslav employees all share in the fortunes of an enterprise — both profits and losses. The definition of profit in the Jugoslav context is equivalent to the non-socialist notion of profit before tax but with wages and fringe benefits added back. The ratio of profit so defined per worker is used to adjust salaries and fringe benefits; the higher the ratio, the higher the pay for the worker, and conversely. Such adjustment is based on a productivity index computed as the quotient of the profit per employee over the average ratio for all firms in the relevant industry. As this index moves, so likewise do wages. As profit flows in above the break-even point, employees get the first slice, often as much as 20%. But as profits increase, the percentage rapidly diminishes so that in the case of a capital-intensive business, operating at reasonable profitability, the employees' share is more likely to be in the 2% to 10% range.

While the Government role in regulating foreign investment is less direct than in Hungary, domestic enterprise autonomy makes legislation the principal mechanism through which national policies on industrial cooperation can be applied. A complex series of laws has been amended periodically, the law in effect at the time of registration being applied.
The Government has tended to broaden permissible non-equity cooperation agreements, and in 1978 began allowing subcontracting or processing of raw materials or semiprocessed goods for foreign contractors. On the other hand, licensing guidelines have been stiffened so as to protect Jugoslav enterprises against excessive restrictions, such as obligatory purchase of intermediate products (aimed at pharmaceutical firms) or restrictions on specific export markets. Licenses are restricted to processes unavailable in Jugoslavia, and both parties must pass on proposed improvements in the licensed process. The Jugoslav licensee must also observe a debt ceiling of 40% of the value of exports or imports, subject to National Bank approval. If the Jugoslav licensee's exports or imports continually run 50% below levels specified in the original contract, the authorities can require settlement, or if disequilibrium continues, declare the contract void. These mechanisms ensure that the agreement remains a true cooperation venture. In countertrade, republic assemblies decree minimum levels (30-50%), individual enterprises presenting the necessary contracts for approval at commercial banks. Failure to fulfil such commitment makes the relevant contract vulnerable to a declaration that it is void. While the duration of contracts may be unspecified, the period of profit-sharing must be clearly stated. All accounting matters must be stated precisely in the final contract. Upon termination, the foreign partner may repatriate the full value of investment. In practice, the joint venture should last a minimum of five years. The joint venture may be dissolved prematurely due to inferior performance or if one partner fails to fulfil contractual obligations. Partners are entitled to dissolve or change the contract by reason of force majeure or rebus sic stantibus (changed circumstances).

Management rights are specified by contract. The foreign partner may be able to obtain equal participation on a Joint Business Board despite a minority position. Since workers' councils retain fundamental authority and approve major decisions of the business board, the contract may establish procedures in case of disputes.
C. **Guaranties.** A foreign partner's investment is guaranteed against nationalization. While the foreign partner in principal has no ownership claim on joint assets, he may retain certain property rights if specified in the contract. The Overseas Private Investment Corporation seems to have played an important role in U.S.-Jugoslav joint ventures, providing protection against expropriation, inconvertibility of funds, and damage to tangible property resulting from revolution or insurrection. Jugoslavia is a member of ICSID, which should make conflicts arising under joint-venture contracts subject to ICSID jurisdiction if so specified in the contract.

D. **Credit Incentives/Disincentives.** None reported.

E. **Tax Incentives/Disincentives.** Profits are generally taxed at 35% after reductions for republic and local taxes, worker benefits, and a risk fund. Reductions are made, however, for reinvestment or for investment in less developed regions (as low as 14%). Additionally, special privileges are granted to Jugoslav enterprises in use of hard currency earnings, tax incentives, and cheaper labor costs. Foreign trade authorities may also issue special permission for the import of equipment and raw materials free of quota or duty restrictions.

F. **Market Protection.** None reported as part of a deliberate inducement for foreign investment or sale of foreign technology.

G. **Subsidy.** The only subsidies are those implicit in the promotional activity of the Government and of the London-based International Investment Corporation of Jugoslavia.

All government levels encourage foreign investment in Jugoslavia, including non-governmental organizations (banks, research institutes, specialized agencies) and the Jugoslav Chamber of Economy (Commerce) with offices in 38 countries. They publicize investment opportunities, interpret Jugoslav regulations, and consult on joint ventures. A series of publications, including annual trade directories, product and enterprise registers, a weekly magazine on the 200 largest enterprises, and economic and statistical tables are published in various languages. Joint bilateral economic councils further promote investment.
Of particular importance is the International Investment Corporation of Jugoslavia, founded in 1969, with offices in London (headquarters), Cologne, Zagreb, and Luxembourg. Share capital is held by 13 Jugoslavian banks, the International Finance Corporation of the World Bank, 42 major banks throughout Western Europe, the U.S., Japan, and Kuwait, with no single group, individual, or country holding a dominant position. It promotes direct foreign investment by: (1) preparing feasibility studies on investment opportunities, (2) offering financial and legal advice, and (3) contributing actual investment or loans for joint projects. The organization has been consulted on or has participated directly in 37 joint ventures valued at nearly $1 billion.

4. EVALUATION

Two aggregate measures may be of significance. First, since 1967, 200 joint ventures have been established in Jugoslavia with foreign firms, the average foreign share being 17.5% and in the aggregate worth an estimated $323 million. Jugoslavia is eligible for more Western financing than other Eastern European countries in that its debt maturity structure is the most favorable in Eastern Europe, with a debt-service ratio in 1977 of 19%.*

There are several ways to judge the relative success of a foreign investment program; one method is to analyze general and sectoral growth patterns. In Jugoslavia, some 18% of total investment per year is financed from foreign sources (IBRD, bilateral loans, and direct foreign investment), direct private investment occupying the smallest percentage (2.5% in 1976). This figure, however, understates the

* Debt servicing cost as a percentage of hard currency earnings.
importance of direct foreign investment since these investments are highly concentrated in sectors vital to the economy. Motor vehicles and related industries account for approximately 50% of total direct foreign investment, followed by chemicals, paper and garment industries. In numbers of products, electrical and electronics equipment accounted for 25%; non-electrical machinery and equipment, including machine tools, 24%; and chemicals, 22%. Growth rates met or exceeded the plan for the 1971-1975 period in overall industry, and in various sectors represented by direct foreign investment, including metal products, electrical equipment, and chemicals. The transport sector lagged behind target. Capital/output ratios have improved for the industrial and transport sectors during the 1971-1975 period, although there is insufficient data to correlate this with changes in efficiency of capital usage.

In terms of meeting employment objectives, employment opportunities have increased, although serious unemployment still exists in the less developed regions. A high of 24% in a less developed region compares to a low of 2% in a developed republic. The problems are compounded by a higher population increase and lower production in these areas. The employment of some 700,000 Jugoslav workers in Western Europe eases the situation substantially.

Trade deficits and hard currency debts increased during the 1970-1976 period, trade growth falling short of targeted rates. Because of its Western trade orientation, the recession in the West and commodity inflation of fuel prices to Jugoslavia were factors over which Jugoslavia had no control. Import dependence has not lessened, and selective rather than general promotion of investment is expected (agriculture, basic raw materials, energy).

Despite tax incentives, most foreign investment has been centered in the more advanced republics of Servia, Croatia, and Slovenia. Approximately 84% of production cooperation and 75% of joint ventures
have been located in these areas. The 1978 amendments, previously mentioned, are aimed at rectifying this situation. However, major impediments are low labor skills, poor productivity levels, and major gaps in the infrastructure in many parts of the rugged central and southern republics.

Overall economic growth has stabilized at 6.1% per annum since the mid-60's, below the Jugoslavian target of 7-7.5%. Regional development, employment creation, productivity, and import dependence remain problems begging solution. Foreign investment is one method of helping to achieve economic goals. However, despite a desire for more direct foreign investment, only half the amount anticipated by Jugoslav planning authorities in the 1970-1975 period materialized. The shortfall has been attributed to the export condition and non-convertibility of the dinar. The conflict between the motivation of market penetration on the part of many Western firms and export promotion by Jugoslav enterprise is a principal issue to be resolved.

While reduction of costs is a prime motivator for investment by many Western European firms, market penetration continues to be the prime motivator for U.S. firms, which form the single largest group of investors (by value).

While considerable attention has been focused on the risks of joint venture under worker self-management, few problems have resulted. In fact, "technocratism" may be a growing trend, resulting in the workers' delegation of more authority to Jugoslav managers.

As of early 1978, the largest joint venture project in Jugoslavia was that which Dow Chemical had organized with INA, the largest enterprise in the country. The agreement involves a major petrochemical complex requiring an investment of $750 million. Dow is to take a 30% equity position in return for an investment valued at $102.9 million in know-how and cash in convertible currency. Dow, however, has a 50% representation on the eight-man "business board."
In the event of a split decision, the matter is to be referred to the General Director of INA and the President of Dow Europe for final decision. The assistant general director, who will be in charge of all matters concerning production and marketing, will be proposed by Dow and approved by the Board. The Business Board has been delegated broad powers by the Workers' Council, the supreme self-management body at the enterprise level. Such authority includes the right to determine profit for distribution and production programs. Important questions reserved for Council decision include job evaluation, pay scales, and cash award system.
BASEMENT

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