Institutions for Investment

IN FOCUS

Establishing a High-Performing Institutional Framework for Foreign Direct Investment (FDI)

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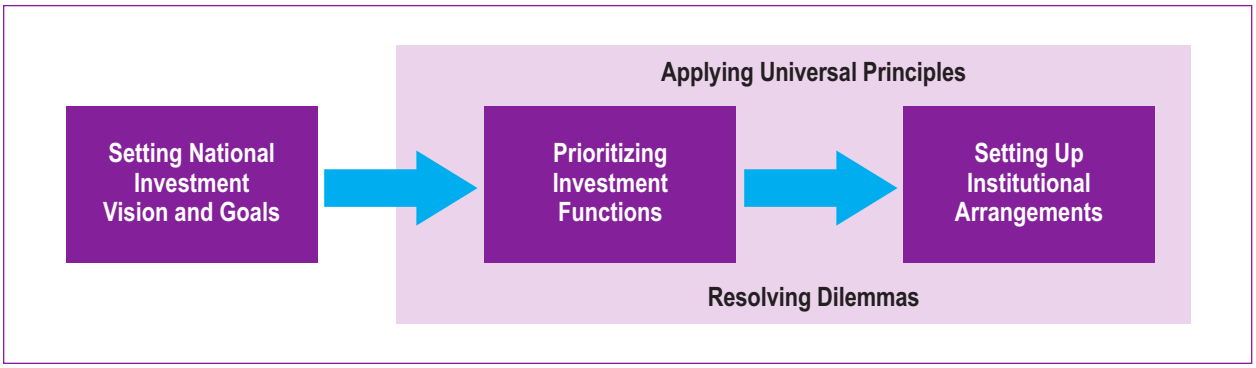
Global experience shows that the right institutional arrangements can result in higher levels of foreign direct investment (FDI). A well-functioning institutional framework requires (a) a shared, strategic vision for FDI across government that includes private sector input; (b) technically capable institutions with clearly defined mandates; (c) institutional stability and sustainability through political cycles; (d) appropriate incentives for institutional cooperation with strong results measurement and communications tools; and (e) political and financial support to establish and staff institutions according to best practices. Not many investment promotion agencies (IPAs) in the developing world can claim to have all these elements; however, working toward these best practices will lead to a more effective institutional framework.

The purpose of this note is to suggest a process for creating optimal institutional structures to deliver a country or economy's investment vision and goals. Specifically, it examines the role of an IPA—the agency usually tasked with operationalizing government FDI goals—in the context of the wider government policy and institutional framework within which it must operate.

First, the note provides the reason for focusing on FDI. Second, it outlines why institutional structures matter in the context of attracting, retaining, and expanding FDI. Third, it describes key government functions for investment and provides examples of institutions that specialize in delivering each function. Fourth, it outlines key principles for the establishment of an institutional framework to successfully deliver FDI. Fifth, the note discusses typical dilemmas that governments face, particularly in the context of institutional specialization versus function consolidation. This note is not designed to be exhaustive of every issue but seeks to provide a summary of the most important relevant issues. It is the first of several planned notes that cover how to position and strengthen IPAs and that identify which services IPAs might offer investors.

Figure 1. Structure of In Focus Note



Why Focus on FDI?

Trade and investment are major components of the national development objectives for almost every country and economy. The attraction, integration, and expansion of FDI play very important roles in most countries. FDI is a source of economic development and modernization, income growth, and employment, and it is a key mechanism with which to connect a country or economy to global value chains. FDI is also a key source of external finance for most developing countries, and often exceeds official development assistance. FDI can contribute to the achievement of Sustainable Development Goals—for example, by attracting environmentally friendly industries and technologies. Echandi, Krajcovicova, and Qiang (2015) set out the benefits of FDI attraction.

The attraction of FDI is a function of a country or economy's having both strong economic characteristics compared to other locations—for example, market access, infrastructure, necessary skills, ease and cost of doing business, and access to suppliers—and sound policies and a strong legal and regulatory framework for FDI. One without the other is seldom successful.

Why Do Institutional Arrangements Matter?

Evidence shows a positive correlation between the quality of a country or economy's public institutions and the attraction of FDI. The World Bank found a positive correlation between the quality score for public institutions from the World Economic Forum's 2018 Global Competitiveness Report (Pillar 1) and the number of FDI projects attracted.[1] Other research confirms that institutional quality affects FDI positively (Kurul and Yalta 2017) and that when institutions are underdeveloped, the benefits of FDI cannot be effectively captured (Nelson 2009).

Efficient institutional arrangements are highly idiosyncratic and must be tailored to work efficiently within a country or economy's specific circumstances (Rodrik 2004; Bauerle Danzman and Gertz, forthcoming). Nevertheless, some important principles, which are discussed below, appear generally valid and should underpin any decisions around optimal institutional setup.

What Key Government Functions Stimulate Private Sector Investment?

Successful private sector investment requires governments to consider and deliver a variety of related functions (see table 1). Most governments will deliver all or most of these functions to foster a vibrant private sector.

The following provides a brief description of each function.

- Policies and laws for private sector development could include domestic investment or FDI, trade, development of small and medium enterprises (SMEs), innovation, special economic zones (SEZs), public-private partnerships, and privatization, among other things. Legislation should be consistent with and aimed at achieving national development objectives, which are perhaps set out in a national development plan.

- Streamlined government procedures for investment should be established and effectively administered. Such procedures include registering companies, paying taxes, applying for incentives, and others. Having too many separate procedures can discourage investors. Business-friendly governments need to look for ways to simplify procedures and reduce the time and cost required for investment projects. More governments are

[1] World Bank analysis of the relationship between the World Economic Forum's 2018 Global Competitiveness Report data on the adequacy of public institutions (Pillar 1) and FDI markets data showed that a 1-point score increase in institutional adequacy is associated with a 23 percent increase in the number of FDI projects. Data from 2007 to 2017 and covering 150 countries were used. The relationship was tested for robustness for the most important confounding factors such as gross domestic product, gross domestic product per capita, average differences between countries and global time trends.

consolidating their procedures into a single "window," sometimes called a one-stop shop (OSS). Increasingly, OSSs offer online portals that reduce corruption, eliminate the need for physical presence, and cut cost and time.

- International legal requirements are complex and have varied effects on trade negotiations; because of this, negotiation and implementation of international investment agreements (IIAs) require specialized skills and resources. The number of IIAs has grown rapidly for the past 20 years and now exceeds 3,000 worldwide. IIAs aim to provide foreign investors entry, fair treatment, and protection, and they also outline investor obligations to the host state. In many countries, IIAs tend to be handled by government offices that are regularly engaged in economic negotiations with other governments. Such offices are usually a specialized unit within the ministry of trade or foreign affairs.

- Services for FDI are often collectively labeled "investment promotion." Such services are designed to persuade foreign investors to (a) select one location over others and then (b) successfully establish, operate and expand in that location. Provision of high-quality services to a globally mobile audience with high expectations requires a clear strategy and strong, service-oriented and well-coordinated institutions.

The implementation of an FDI strategy usually involves several functions and institutions acting in concert—namely, investment policies, which are the responsibility of the lead ministry; IPAs; SEZs; OSSs; and private sector and other stakeholders.

Table 1. Government Functions for the Generation and Administration of Private Sector Investment

Critical Area	Functions	Examples of Specialized Institutions
Policies, laws, and regulations	Making policies and laws for private sector development	Ministerial council, office of the president or office of the prime minister, responsible ministries
	Administering government procedures for investment, including incentives	Relevant ministerial authorities, OSSs
	Negotiating and implementing IIAs	Ministries of economy, investment, trade, foreign affairs
Services to address market failures	Providing services to foreign direct investors, including marketing, information, assistance, and advocacy across the investment cycle	IPAs, SEZs, OSSs
	Providing services, including financial assistance, to domestic investors, including start-up, micro, and SME support; export promotion; linkages; and outward FDI promotion	SME agencies, trade and export promotion agencies, development agencies, incubators, specialized development finance institutions
Investor grievances and dispute resolution	Handling investor grievances and resolving investor disputes	IPAs, investment ombudsman, prime minister's office, ministry of economy, courts, ADR mechanisms (such as arbitration centers)
Other relevant private sector investment functions	Administering economic zones and public lands; designing, negotiating, and administering PPPs and public concessions; administering privatization and SOEs	SEZs (and similar industrial and business parks), government PPP and privatization units, individual asset-owning ministries, SOE units

Note: This list contains the main functions necessary for a successful private sector investment program. It may not be exhaustive. IIA = international investment agreement; FDI = foreign direct investment; SME = small and medium enterprise; PPP = public-private partnership; ADR = alternative dispute resolution; SOE = state-owned enterprise.

Many countries identify the IPA as the main agency that coordinates these wider FDI implementation efforts—but not FDI policy—and that directs the country or economy's marketing efforts for new foreign investment. For example, Invest Hong Kong, Invest India, and Invest in Turkey all lead their respective country or economy's FDI efforts.

- Services for domestic investors usually include financial and other support for start-up, micro, and SME businesses, as well as export promotion, linkages, and outward FDI promotion. These services can be seen as a continuum to help domestic companies progressively grow and, for those with the objective, to internationalize (see figure 2).

  Development financing often involves SME grants and lending, trade finance, or outward FDI finance. For example, India's Export-Import Bank provides financial assistance to exporters and importers, while South Africa's Industrial Development Corporation provides financial assistance to support firms seeking to invest abroad.

  The delivery of such services usually falls to three types of institutions. The first type is SME support agencies. For example, South Africa's Seda (Small Enterprise Development Agency) and Brazil's SEBRAE (Serviço Brasileiro de Apoio às Micro e Pequenas Empresas, or Brazilian Micro and Small Business Support Service) are mandated to implement the government's small business strategy through a range of SME programs.

  As firms grow, they may wish to move into export markets. Support for such a move is usually provided by the second institutional type, which are known as trade promotion organizations or export promotion agencies (EPAs). For example, Costa Rica's PROCOMER delivers programs to help SMEs diversify their exports, while the International Trade Board of Madagascar provides export support to traditional handicraft SMEs.

  Finally, once a company has successfully moved into export markets, it might consider establishing production or distribution overseas. The third type of institution, such as Apex-Brasil, the Korean Trade-Investment Promotion Agency (KOTRA), or the Japanese External Trade Organization (JETRO), provides support to potential outward investors.

- Handling investor grievance and resolving investor disputes in an efficient and timely manner is important. However, investors often find it challenging to have their grievances addressed in a timely and effective manner. Resulting frustration can translate into FDI withdrawals and expansion cancellations or, in some cases, escalation to investor-state disputes. Governments should identify and manage grievances between investors and public agencies as early as possible. A lead agency should react in a timely and coordinated manner to resolve grievances well before the investor opts to divest or to take the country or economy to court. Access

Figure 2: The Internationalization of Domestic Firms

Source: WBG presentation of main stages of domestic firm growth.
Note: SME = small and medium enterprise.

to fair and efficient court systems and alternative dispute resolution mechanisms are necessary to enforce investor rights.

- Other relevant private sector investment functions include leveraging public assets to support private sector investment. First, the administration of public land and real estate is usually managed by authorities such as SEZs, industrial parks, or export-processing zones. For example, in the state of Pernambuco, Brazil, Suape operates a large SEZ that hosts domestic and foreign investors in several strategic clusters. The Couga SEZ successfully does the same for a province in South Africa.

  Second, PPPs, public concessions to private investors and privatization, and SOE programs are also important mechanisms for investment. These functions directly seek private investors—domestic or foreign—to support government-conceived projects and are often carried out by specialized units within the institution that owns the relevant asset. Sometimes, a centralized government unit will administer the overall program. Teams that concentrate skills on PPPs are often called PPP units. Their functions vary widely, as do their structures and location within government, which reflects different priorities across government. However, PPP units often deliver (a) policy guidance and capacity building; (b) PPP promotion both within and beyond government; (c) technical support in implementing PPP projects; and (d) gatekeeping or overseeing the approval and management of PPP projects.

  Many countries establish central PPP units within the ministry of finance, including the United Kingdom, France, South Africa, and India, whilst other countries have established PPP units within the ministry of planning or elsewhere. In Chile, for example, the Concessions Unit reports to the Ministry of Public Works, while the Philippines' Public-Private Partnership Center reports to the National Economic and Development Authority.

What Key Principles Should Governments Consider When Establishing the Institutional Framework for FDI?

Ideally, having identified the functions necessary to deliver agreed-on FDI goals, governments should decide how to best structure and organize the institutions that will deliver the selected functions. In practice, however, this sequencing is often not followed. Countries must therefore adjust and reform both functions and institutions to achieve the best results.

Evidence indicates that institutional structures and governance arrangements significantly affect the effectiveness of FDI promotion efforts (ECORYS 2013; Lim 2018; Wells and Wint 2000). If poorly designed, FDI-related institutional clusters can be constrained by incompatible functions housed in the same institution, inadequate resource allocation, conflicts of interest, duplication or gaps in service delivery, and poor coordination, all of which can lead to weak FDI performance.

The following principles are based on a review of relevant academic literature, new empirical research, and more than 30 years of World Bank Group operational experience. The summarized conclusions of these sources suggest that institutions in developing countries are most effective when the seven principles listed in box 1 are applied.

- Nelson (2009) shows that a strong institutional framework requires a shared, strategic vision for FDI across government that also includes private sector input, thus ensuring that all relevant policies and institutions are aligned and coordinated. For example, the United Nations Conference on Trade and Development's World Investment Report 2018 says that, to be effective, "investment policies need to revolve around a clearly articulated vision but, at the same time, they have to contain ... a clear ... division of responsibilities among the public and private sectors" (UNCTAD 2018, v). Without a shared vision, a country or economy runs a high risk of contradictory and conflicting policies and actions that will weaken FDI results.

Box 1: The Key Principles for Effective FDI Institutional Arrangements

- A strong alignment across government that stems from a clear national development plan or objective, vision, or strategy—including FDI—with clear priorities and sequencing;
- Government support for FDI promotion from the highest level (for example, the president or prime minister) that directly or indirectly champions the needed policy, legal, regulatory, and institutional reforms;
- Systematic and reform-oriented consultation with the private sector;
- A strong, clear, and uncontested mandate for each institution that also stems from the national development objectives and avoids any possible conflicts of interest;
- Sufficient and sustained financial and human resources to properly deliver the mandate of each agency;
- A clear focus on results management; and
- Strong partnerships and coordination mechanisms with both public and private sectors at both national and subnational levels to ensure consistency between institutions.

- High-level political support is essential in aligning and implementing often-difficult multistakeholder reforms for investment. For example, IPAs tend to be more successful with more political support. Lim (2018) and Ecorys (2013) conclude that investment agencies with operational independence (often referred to as quasi-autonomous agencies[2]) and with high-level government support tend to have a better effect on FDI attraction.[3] This is sometimes reflected in the level of government to which the institutions report. For example, the Ethiopian Investment Commission reports to the Ethiopian Investment Board, which is chaired by the prime minister. But often this positive effect has less to do with an institution's direct reporting lines to a high level of government than it does with the institution receiving high-level government support when it is needed. For example, Invest India reports to the Ministry of Commerce and Industry but has strong direct support from India's prime minister.

- Best practice requires systematic consultation with the private sector in the development of trade and investment policies if government expects serious uptake by domestic and foreign investors.[4] Government can leverage the private sector's experience to enhance the content and prioritization of policy reforms and the effectiveness of public service delivery. Public-private dialogue mechanisms provide a systematic way to identify key reforms.

[2] They are referred to as quasi-autonomous because IPAs are, of course, typically funded by government resources. Therefore, they cannot be wholly autonomous. What the research means by "autonomy" is a high level of decision making on how best to operationalize the FDI strategy.

[3] Bauerle, Dangman and Gertz (2020) identify trade-offs between autonomous agencies (which can set their own priorities and are often viewed as more legitimate in the eyes of investors and more integrated agencies (which can help facilitate coherence in strategy and confer high level political support, but can be susceptible to bureaucratic inefficiencies and interest group lobbying.

[4] The European Bank for Reconstruction and Development has been working to help governments establish investment councils as public-private consultation mechanisms since 2007. For example, in the Kyrgyz Republic, the council has contributed to the adoption and amendment of more than 100 critical laws and regulations since 2007. See https://www.ebrd.com/what-we-do/sectors-and-topics/investment-councils.html.

- Each institution should have a clear mandate that does not overlap or contradict others. Evidence shows a negative correlation between the number of mandates of an IPA and FDI inflows (World Bank forthcoming). World Bank operational experience[5] indicates that development of institutions with too many mandates typically takes much longer to deliver substantial results. Lim (2018) finds that FDI performance is negatively affected when promotion of inward investment functions is combined with export promotion or the promotion of outward investment.

  For example, in one Asian country a single agency is tasked with promoting investments, implementing public investment programs and sustainable development goals, implementing PPPs, and negotiating IIAs with very limited resources to deliver any of these goals. In an African country, a single agency is tasked with formulating trade and investment policies, promoting investments and exports, administering SEZs and incentives, and developing SMEs, all with only about 20 staff members and scarce financial resources. Both agencies are struggling to deliver against the many investment-related functions given to them. These countries need to reconsider their institutional framework and the resources required if they are to attract FDI and achieve national development goals.

  An important aspect of the institutional mandate is that there should be a clear distinction between policy making and implementation. Best practice sees policy making as an upstream function that is undertaken by a relevant ministry, while implementation is a downstream function that involves more direct interaction with companies and is usually the responsibility of operational agencies such as IPAs.

- Given the longer-term nature of investment, investment institutions need sufficient and sustained financial and human resources over at least a three-year period to deliver the agency's agreed-on strategic goals and to avoid disjointed efforts from year to year, struggles over funds every year, or having to charge fees. Nelson (2009) points out that institutional stability and sustainability through political cycles are best practice. An IPA's performance can be enhanced by having key management and promotion staff members with strong private sector experience, international exposure, and language skills and who are not affected by political transitions.

- An IPA's performance can be enhanced by a clear focus on results management. IPAs need to have in place a mechanism to collect data on results, as well as the ability to analyse these data and to take corrective actions where necessary if the desired results are not being achieved.

- Institutional collaboration and communications also affect FDI impact (Miškinis and Byrka 2014). Results from a 2017 World Bank survey of IPAs shows that IPAs in high-FDI countries coordinate more, with 95 percent of them maintaining close or regular contact with other institutions, as opposed to only 68 percent of IPAs in low-FDI countries.

These principles should shed light when policy makers face the typical dilemmas discussed in the next section.

What Typical Dilemmas Do Policy Makers Face When Creating an Institutional Framework for FDI?

On the one hand, the need for coherence might be seen as a good rationale for consolidating functions in as few institutions as possible. On the other hand, policy makers should consider that each function requires a unique set of characteristics for success, which might argue more for specialized agencies implementing each function. The right balance depends on the country or economy's circumstances. Suitable coordination mechanisms between the

[5] Survey in 2019 of senior World Bank experts in investment policy and promotion.

specialized institutions play an important role in ensuring consistency and coherence.

When considering the allocation of functions to individual institutions, governments often lean more heavily toward consolidation of functions than toward specialization. However, these decisions are not as clear cut as they might seem and can often lead to unintended consequences. The following sections review the functions most commonly combined within an IPA and assess their appropriateness.

Most countries have a national IPA that must work in coordination with subnational IPAs and with other relevant agencies to ensure that incoming investors are served well. Essentially, IPAs are specialized marketing and service-providing agencies; their focus is on (a) identifying potential investors through articulating a convincing case for locating in their country or economy and (b) providing quality, on-time services to prospective and established investors. One must recognize that, in FDI promotion, it is more often quality than quantity that matters. Quality services require dedicated budgets and specialized staff members capable of understanding investors. This, an IPA's technical capacity is far more important than its staff headcount.

Nevertheless, there is often a temptation to combine investment promotion functions with wider investment and trade functions, but such decisions are fraught with difficulties.

Should IPAs carry regulatory functions, such as investment approvals, incentives, and investment monitoring? In some countries, IPAs are part of an authority with a broader mandate to regulate FDI and, sometimes, domestic investment. However, investors are often confused when dealing with agencies that both support and regulate FDI. Investors prefer clarity of roles. World Bank experience shows that in agencies with both promotional and regulatory functions, the promotional functions tend to underperform. Priority is always given to the regulatory side. Studies such as that by Whyte, Ortega, and Griffin (2011) argue that assigning regulatory functions to IPAs in fact will prevent the IPA from focusing on its already complex and demanding role of FDI promotion. If functions are combined, strong division of functions is essential.

In most countries and economies that have succeeded in attracting significant FDI, IPAs do not typically have regulatory functions. Successful IPAs such as Invest Hong Kong, ABA–Invest in Austria, and CINDE carry no regulatory functions.

One specific dimension of the division of functions relates to investment incentives. In some countries, IPAs have been charged with managing incentive programs on behalf of government. Unfortunately, this arrangement again puts the IPA in the difficult situation of acting as persuader, supporter, and rewarder (of incentives) for the investor while also having to assess and monitor those incentives. This represents a conflict of interest. In other words, it is in the IPA's interest to incentivize the investors it is trying to persuade to locate in its country or economy, rather than to consider incentive awards objectively. It is, however, not in the IPA's interest to then become the government's "police officer" who monitors and potentially punishes the investor if there is a breach in compliance with incentive conditions. These latter tasks are better carried out by an independent government entity—for example, a unit within the ministries of finance, industry, or economy.

What about amalgamating the IPA with the EPA? IPAs and EPAs essentially have quite different operational roles (see table 2). IPAs deal with medium to large foreign firms that seek to locate in the host economy. while EPAs deal with small- to medium-sized domestic firms that seek to sell their goods and services overseas. These are very different audiences and markets that require different programs, as well as different staff skill sets. Lim (2018) finds that FDI performance is negatively affected when inward FDI and export promotion are combined within the same organization.

World Bank experience shows clearly that combining the different functions of investment and trade in a single organization is far from simple. Combining functions does not automatically result in synergies and even tends to leave one of the two functions behind—invariably investment—unless

institutional and staff objectives, resource allocation, and internal processes are structured to reflect the differences between the two functions.

Nevertheless, certain cost savings may stem from sharing corporate services, particularly finance, legal, information technology, and human resources. Some operational synergies may also exist, as, for example, when incoming FDI firms are also exporters and IPA and EPA staff members are required to work closely together to maximize such opportunities (UNCTAD 2013). Some agencies with combined functions have been successful on both export and investment counts, such as the United Kingdom's Department for International Trade. However, such agencies have structured internally to ensure that the two functions essentially operate as separate units and report to a chief executive officer and board that covers both functions. Operationally, the agencies have separate budgets and enabling environments, as well as dedicated, highly trained staff members, while still working together when necessary.

This note advises that care should be taken to keep these two functions separate, either in separate agencies or in distinct units within a single agency.

What about other linked operational functions? The final section addresses three functions with which the IPA must work closely.

- OSSs are increasingly regarded as a tool to help investors navigate through regulations and procedures. OSS responsibilities are often given to IPAs because of poor investment climate, mission creep, budget constraints, or political considerations.

  Global experience suggests, however, that OSSs should be independent of IPAs but that the two entities should have a strong working relationship. This is because OSSs should provide services to both domestic and foreign investors. The operational needs of an OSS differ from the IPA's promotional needs and can cause significant conflicts of interest. Promotion usually suffers when OSS and IPA functions are performed by the same agency. Most successful IPAs around the world do not host the country or economy's OSS—for example, those in the United Kingdom, Ireland, Austria, Hong Kong, and Costa Rica. These IPAs provide guidance and information to investors on how to contact and work with the OSS.

- SEZs and industrial parks interest potential investors. However, IPAs should not be in charge of SEZs because of the potential conflict of interest. If the IPA is given responsibility to make economic zones successful, there will be considerable pressure on the IPA to push

Table 2: Contrasting EPAs with IPAs

	Export Promotion	Inward FDI Promotion
Mandate	Support domestic firms seeking to sell goods and services in international markets	Target foreign investors to attract, retain, and expand FDI into host country or economy
Clientele	Domestic producers (typically small and medium firms)	Foreign investors (typically medium and large firms)
Decision makers	Buyer agents in the importing firms	Top-level executives responsible for investment decisions
Staff skills	Sales and marketing officers with sector knowledge in overseas markets, international exposure, languages	Political economy, public relations, marketing and sector-level knowledge of business in source and host countries, international experience, languages
Performance indicators	Export value and volume, number of new markets, number of new exporters	FDI inflows, number of investment projects, number of jobs created

Note: EPA = export promotion agency; IPA = investment promotion agency; FDI = foreign direct investment.

investors toward a zone's location in an effort to fill it. However, in many instances, zones may not be the best choice for an investor who may prefer a different location or, indeed, a private sector property solution.

Outward investment promotion is very different from inward investment promotion, among other things targeting different types of firms. Inward investment deals with experienced medium and large foreign companies that often consider many overseas locations, whereas outward investment typically deals with large domestic firms that are taking the first steps to locate overseas. Combining inward and outward investment in the same organization is unlikely to be the best institutional structure because it diminishes the FDI impact (Lim 2018). Outward FDI sits better within specialized development and trade promotion organizations implementing an "internationalization of domestic firms" strategy. There are clear dangers in mission creep in terms of distracting an IPA from its core mandate. Nevertheless, one exception to this can be where IPAs have proved to be ideal places for government to incubate new investment-related functions before transferring such functions—once a concept is proven—to a more appropriate institutional home.

Conclusion

How governments structure their institutional framework for investment is important to achieve development goals. Given that institutional arrangements need to be tailored for different national circumstances, it is important that the institutional structure is driven by national priorities and closely follows the principles set out in box 1.

These principles suggest that a shared, strategic vision for investment that includes private sector inputs; high-level government support for FDI promotion; clear institutional arrangements with well-defined, non-overlapping mandates; adequate resources to deliver agreed-on goals; strong focus on results management; and strong collaboration and communications across government, with the private sector, and with other stakeholders are all critical to a well-functioning institutional structure.

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