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Encouraging Modern Governance and Transparency for Investment: Why and How?

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ENCOURAGING GOVERNANCE AND TRANSPARENCY FOR INVESTMENT

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Apart from a handful, in the last few years many developing countries have not benefited from the open trade and investment regime. The gap between the haves and the have-nots has increased in the last half a century even though the world has gained in terms of social and health indicators in this period more than any other of human history. This happened despite the fact that increasing amount of development finance in various forms – grants, aid, loans and foreign investment – has flowed into developing countries in this period. One of the reasons identified for lower effectiveness of development finance is poor economic and political governance in many developing countries.

The report of the High Level Panel on Financing for Development, popularly known as the Zedillo Report[1], identified foreign direct investment (FDI) as one of the major sources of finance for development and one of the recommendations it gave to developing countries is to ensure governance based on participation and the rule of law, with a strong focus on tackling corruption, which in turn would put their economic fundamentals in order.

FDI may also have an effect on governance and transparency. Some studies have shown that the presence of foreign investors in some cases has promoted good governance among governments as well as the domestic sector. However, in the last couple of months the issue of corporate malpractice has rocked

[1] The Panel was appointed by Kofi Annan, the UN Secretary General "to recommend strategies for the mobilization of resources required to accelerate equitable and sustainable growth in developing countries as well as economies in transition, and to fulfill the poverty and development commitments enshrined in the United Nations Millennium Declaration". The report was discussed at the International Conference on Financing for Development in Monterrey, Mexico on 18-22 March 2002

the world. The corporate scandals in the USA involving Enron-Andersen, Worldcom etc. have given rise to several concerns. One of the concerns is that in developing countries big foreign companies are less transparent and have poorer corporate governance than in developed countries.

Therefore, along with developing countries, big corporations should also improve their system of working. Especially when they enter developing countries, foreign investors should take steps to contribute to development process including strengthening of corporate governance.

Strengthening Governance in Host Countries

Recent few years have experienced a lot of debate and discussions on governance. Before discussing the effect of governance on investment, we will discuss what is good governance. Broadly, elements of good governance can said to be consisting of state of law, well functioning judicial system, consistent system of law, effective implementation of laws and rules, stable political climate and established consultation procedures with the stakeholders e.g. firms, government, shareholders, consumers, civil society organizations etc[2]. Various organizations/institutions rank countries according to their record in governance. These indices are taken seriously because poor governance has some social and economic costs.

Poor governance breeds corruption, raises information cost for investors and encourages rent-seeking activities. Poor governance also has an adverse effect on the morale of the citizens of a country. Poor governance may discourage investment by creating barriers to market entry and increasing operating costs. A Foreign Direct Investment Survey conducted by Multilateral Investment Guarantee Agency (MIGA) in 2001 reported that when investors invest outside their home countries, the most important objectives in their mind are improved market access and reduced operating costs. The Organisation for Economic Cooperation and Development (OECD) report "Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs" similarly says that host country transparency and the rule of law are among the top concerns of investors.

The adverse effect of corruption on FDI flows is also corroborated by the findings of the project "Investment for Development" (IFD)[3]. The project, implemented by CUTS Centre for Competition, Investment and Economic Regulation, studies investment regimes in developing and transition economies. The project finds that corruption has impeded FDI flows in some of the project countries. As an example, the case of Tanzania can be quoted: red tape in the investment establishment in the country is acting as a hurdle for investors. Most decisions related to investment are made at the central level, investors interact with local government only during the consultation process and following establishment of the businesses in their area of jurisdiction. The main business permits and licenses are issued at Dar-es-Salaam. The process of setting up business in the country, as a result, becomes time-consuming and costly for investors. This, in turn, discourages foreign investors from entering the country.

As a solution, the government has been urged to decentralise licensing procedures. It has also been suggested that the investment promotion agency, Tanzania Investment Centre (TIC) should open branches in different regions to streamline procedures.

The problems, which commonly affect governance adversely as found in the IFD project countries:

1. Poor legal framework such as outdated and inadequate laws;

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[2] OECD 2002a

[3] See www.cuts.org/ifd-indx.htm

2. Poor overall and sectoral investment policies as well as weak enforcement mechanisms;
3. Uncertainty and instability in the policy environment;
4. Lack of some comprehensive policies;
5. Poor enforcement of laws and policies;
6. Unstable and inflexible tax structure, which in turn increases operational costs; and
7. Rigid labour policies and regulation.

There is a caveat: though good governance does have a positive effect on FDI inflows, there are variations in inflows within countries with the same level of governance since there are other factors influencing FDI flows. The other factors could be internal or external to a country. Internal factors could be the policy framework for FDI, economic factors or the type of business facilitation means existing in a country. External factors could be global economic condition, regional markets etc.

As an example, of countries with same level of governance but receiving different levels of FDI and countries with different levels of governance but receiving similar level of FDI, the case of Nigeria, South Africa (SA) and Brazil can be cited. Transparency International ranks 133 countries on the basis of level of corruption and brings out an annual Corruption Perceptions Index (CPI). CPI 2003 has ranked Nigeria among the most corrupt countries at 132, and Brazil and SA among the middle level corrupt countries at 54 and 48 respectively[4]. Interestingly, as per the UNCTAD World Investment Report 2003, these three countries have nearly the same ratios of inward FDI stock to GDP, which are 44.0 for SA, 43.6 for Brazil and 41.6 for Nigeria. However if we consider FDI inflows in 2002, Nigeria received about US$1.3bn and SA US$ 0.7bn but Brazil received US$ 17bn.

Therefore, the link between governance and the level of FDI inflows is not very strong. However, it can be said that given other factors, countries with definite, predictable and enforceable rule of law, efficient judiciary, low corruption and lower concentration of ownership tend to attract more investment than countries, which do not have the above.

One aspect of good governance is transparency: A non-transparent investment regime is the result of poor governance. The next section discusses various aspects of transparency. A point to be noted is that often investors are willing to enter a country if rules are transparent even if a few other conditions do not exist. For example, if a country does not provide investment incentives but has a transparent regime, firms are usually more willing to invest in it rather than in the countries, which provide incentives but have a non-transparent regime. The converse is more applicable: investors are unwilling to enter a country with poor governance and transparency, except for certain kinds of resource seeking investment e.g. the presence of oil companies in Nigeria or Angola.

Transparency in Investment Regimes

Transparency is one of the most important elements of the enabling environment, which can be influenced by policies. It is difficult to quantify transparency or isolate it from other policy aspects that influence FDI but it is easier to gauge the effects of transparency. Transparency leads to free flow of information and clear, speedy and proper implementation of laws and rules. It facilitates governmental

[4] See http://www.transparency.org/pressreleases_archive/2003/2003.10.07.cpi.en.html

accountability and predictability of outcomes. It also curbs any discretionary power enjoyed by government officials or multiple interpretation of laws and rules.

One important factor related to transparency is said to be "the degree of social cohesion and stability of a host country"[5]. If cohesion and stability is absent in a country, it adversely affects investors' perception about a country. In addition, investors may be concerned about possible damages to their reputation if they operate in such a country. Investors also hesitate to invest in a country with non-transparent regime because it raises costs and gives rise to all-round corruption.

There is a strong link between transparency in policies and the regulatory structure in a country. Therefore, along with analysing the nature of rules applied to foreign investment, the extent of transparency in the implementation regime should also be analysed. Business environments are often non-transparent, even after governments take policy measures to improve the environment, if the measures are not properly implemented. Unless there are existing rules restricting activities of foreign investors, implementation is more important than policy changes in shaping-up investors perception on an investment regime.

A study conducted by S Ahn and J Chan-Lee[6] concludes that "better functioning legal systems and governance and better enforcement appear to be more important than legal origins *per se* in terms of their impact on development". Their study shows that countries that received higher FDI flows (between US$30mn to 60mn) have high scores in institutional governance on a scale of 0 to 1.

While a transparent regime facilitates FDI, the converse is also true: FDI may also facilitate a transparent regime. The presence of foreign investors may lead to more open government practices, promote corporate social responsibility and corporate governance, and assist the fight against corruption.

The importance of transparency and governance in attracting FDI could be seen from the experience of China and India. According to the UNCTAD World Investment Report 2003, China attracted US$53bn in 2002 becoming the highest FDI recipient in the world. India, in contrast, attracted only US$5.5bn in the same year. While there are questions on the long run effect of the country's dependence on FDI and the quantity of FDI it actually receives, it is widely acknowledged that high growth rates in China are both a cause and effect of high FDI. The other factor influencing the growth rate in China is the country's pragmatic approach to FDI.

The country has a business- and FDI-friendly attitude with simpler FDI procedures and quick decision-making. The country has more flexible labour laws, better labour climate and better entry- and exit-procedures for business than India. Moreover in 1979 when China opened its doors to foreign investors, investors' perception of India was at its nadir due to throwing out of companies such as IBM and Coca Cola. China has also concentrated on developing its infrastructure and human development indices. Therefore, apart from policies, their implementation makes a big difference to an investment environment.

There are two aspects of transparency: actions taken by authorities and the broader business environment of the host country. Since FDI has a long-term perspective, if foreign investors feel that legislative environment and rules enforcement in a country is uncertain, they might hesitate to invest in it. Such uncertainty raises the risk of operating in a country. This also gives rise to fear of discriminatory treatment. Maintenance of a transparent regime is considerably costly and requires effort. However, this should be compared with the cost incurred by investors when the investment regime is non-transparent.

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[5] OECD 2002b

[6] OECD Observer No.234, October 2002

Steps to Improve Transparency and Governance

This section describes some steps, which host country governments could adopt to promote transparency and good governance.

To start with, countries should consolidate the rule of law, strengthen policy and regulatory framework, and reduce corruption.

Open trade regimes enable domestic enterprises to participate in the global economy, which promote competition and efficiency, and reduce concentration in the domestic market. This also makes the host economy more attractive to foreign investors. Therefore, countries should open their trade regimes with necessary precautions. This creates a more open environment, which facilitates good governance and transparency.

The investment regime should not discriminate between domestic and foreign investors. Some positive discrimination in favour of domestic investors on the basis of infant industry argument can be made but it should be done without giving any scope of increasing monopoly and concentration.

The existence of adequate and good physical, financial and social infrastructure has an important effect on the investment environment. Once countries strengthen their infrastructure, it reduces cost of doing business and corruption. This makes the country attractive as an investment destination.

Besides maintaining transparency in investment regime, transparency and good governance among firms should also be ensured to encourage higher beneficial investment. The next section discusses the issue of transparency in corporate affairs.

Governance and Transparency in Corporate Affairs

It is also important to discuss governance and transparency in firms because good governance and transparency should be maintained all around. There is a link between governance and transparency in an investment regime and that in the firms.

Often foreign investors tend to choose a location with weak or relaxed regulation. This kind of ‘competitive deregulation’ exists not only between countries but also between regions or states within countries. This creates a race to the bottom in relaxing regulation. This gives the firms the freedom to disregard the standard labour, environmental or economic practices. This might lead to unbalanced growth, worsened distribution of income, high degrees of pollution, etc.

There are several instruments to ensure good governance and transparency in a firm. Various terminologies are used to denote these: corporate social responsibility, codes of conduct, voluntary initiatives, stakeholder accountability, etc.

The content of these instruments can be divided into three groups[7]:

Social – Including employment, training, working conditions, industrial relations and force

Environmental – Including management policies, input/output, stakeholders, finance and sustainable development

[7] Brett Parris, “*Foreign Direct Investment and Corporate Codes of Conduct in National Development Strategies: Costs, Benefits and Policy Options”*(OECD: 2002b)

Generic – Including consumer interests, communities, global development, ethics and legal requirements

There are various studies on the effectiveness of the instruments in influencing business behaviour. Some studies suggest that for most companies, adoption of such instruments are mere eyewash, these are simply public relations exercise. Most of these instruments do not have any index to measure their effectiveness. Again, many of these instruments are quite general leaving much room for interpretation. Lastly, most of these do not have proper compliance mechanism or independent monitoring system.

A study by the OECD[8] found that there are major omissions in many of the instruments such as a majority of these do not mention disclosure of relevant information or competition. Only 32 per cent of the firms have made any commitment against political contributions and only 1 per cent mention the issue of taxation. Firms have also used less stringent voluntary instruments to escape stricter binding legislation in many host countries.

In spite of all the drawbacks, these voluntary or semi-binding instruments do have an influence on an investment environment. However, a sound national institutional environment is more important for ensuring good governance and transparency in a country. In the presence of properly functioning institutions, corporate governance instruments, at the most, act as a strengthening mechanism for the existing investment environment. However, if the legal and political environment is less than ideal, these are also useful in encouraging responsible corporate behaviour. Still, there is no substitute to good national institutional framework in a country.

Institutions to Govern

This section examines the importance of institutions – formal or informal in ensuring good governance. The institutional setup and instruments, which ensure governance in firms, can facilitate investment by making it possible to accumulate resources so that firms have easier access to finances and entry into markets easier. Institutions, which affect governance of firms, determine who has the right over resources both within and between countries.

The World Bank World Development Report 2002 quotes a study that examined the efficiency of resource allocation among firms. The study says that not all the firms examined have effective governance. Formal governance institutions increased opportunity for these firms by promoting investment in high value added activities. However, formal governance institutions require the existence of complementary institutions and depend on the capacity of the country. In countries, which experience arbitrary state actions, contracts are weakly enforced and information flow is poor, private institutions are more prevalent than formal institutions.

To promote good governance and transparency, policies that bring about legal reforms such as openness in trade and freer flow of information, and create demand for new institutions are as important as the specifics of individual reforms. In other words, the nature of policies is as important as the content of policies.

Further, large firms require different form of governance than small firms. Large firms are less numerous but account for a significant proportion of productive output and employment. Weak governance of these firms has led to corporate scandals, and financial and economic crisis. However, big firms have also contributed significantly to economic growth. Therefore, it is important to ensure that these firms have proper governance.

[8] *Ibid*

As noted earlier, many developing countries lack the capacity to build effective formal institutions for ensuring good governance and transparency and thus need assistance to spruce up their institutional structure. They need both technical and financial assistance in this regard. A major concern of developing countries is that they lack resources, and aid has fallen drastically in the last decade. They cannot depend on FDI for resource generation because foreign investors would not consider entering their countries unless these countries can ensure good governance and transparency.

How to Benefit from Foreign Corporate Presence?

From the earlier discussion it can be concluded that countries might be able to benefit from foreign corporate presence if they can ensure good governance. Countries could take the following steps to ensure this:

Firstly, it should be recognized that though FDI can contribute to economic development, it has not done so in many countries so far. Aid is still required for many of the developing countries especially many least developed ones for poverty reduction programmes. Whether FDI will benefit a country or not does not solely depend on the type of FDI or the type of foreign investor. It also depends on socio-economic conditions of a country including the existence of well functioning institutions, and transparency and good governance among these institutions.

Secondly, it is important to help developing countries to build or strengthen their institutions. These countries by themselves should also take steps to improve their institutional capacities. For many of these countries, this requires a strong political will.

Thirdly, FDI should be seen only as a part of national developmental strategy, which fosters domestic capacities and domestic investment.

Fourthly, incentives race might hurt a country by leading to competitive deregulation. This might hurt a country fiscally or financially depending on the kind of incentives provided. Bilateral, regional or multilateral agreements should have clauses to restrict any incentives race. Countries by themselves should resist the temptation to provide incentives.

The OCED report "Foreign Direct Investment for Development: Maximising Benefits, Minimizing Costs" says that sound policies are important to attract and reap benefits from foreign corporate presence and these are very similar to the policies, which encourage domestic investment. Measures to benefit from FDI can be classified into three categories: firstly, improve general macro-economic and institutional frameworks; secondly, strengthen or restructure the regulatory environment; and thirdly, physical, financial and social infrastructure should be boosted.

While the first of these measures is directly related to good governance and transparency, second and third have indirect links. It cannot be guaranteed that countries will be able to attract FDI or benefit from it if they improve their governance but it is one step forward towards creating an enabling environment for investment.

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