

Foreign Direct Investment and National Competitiveness – Financial Aspects

Adnan Rovčanin, University of Sarajevo

KEY WORDS : FDI Policy, Competitiveness, Bosnia and Herzegovina

JEL : E21, E22, F21

ABSTRACT: *Renewed confidence in the positive benefits of FDI to the economic development of the host country has led many countries to be more open towards FDI since the beginning of 1990s.¹ As a result of increased liberalisation and technological advances, FDI flows rapidly increased during last few decades. FDI increased as a ration of domestic investment and GDP in many countries (UNCTAD, 2005). However, while some countries attracted large FDI flows, others were less successful, even though they had liberalised FDI regimes. A huge number of different studies on the impact of FDI on economic growth and productivity of domestic economy have been published.² A general conclusion of these studies is that the benefits of the foreign companies in terms of economic development, even though they possesses a bundle of desirable assets (including a long-term external financing, new technology, skills, management practice and market access), and in general they are more productive, pay higher wages and are more export intensive than local firms, are by no means automatic. In addition, researches showed that FDI can also lead to some less desirable or undesirable outcomes such as rising inequality between individuals or groups of individuals in the society and between the regions, direct or indirect crowding-out of local capabilities or an erosion of the tax base or labour and environmental standards. Development of the local absorptive capacity (skills, R&D, infrastructure and etc.), is of the key importance in shaping the ultimate effect of FDI, suggesting an important role of complementary policy. Different programmes of encouraging linkages between TNCs and local firms, programmes supporting clusterisation and upgrading FDI are also approved as important. In this paper we analyze appropriate role of FDI policy in raising national competitiveness. The first section discusses the role of FDI in technology transfer, learning and competitiveness. Here we analyze benefits and costs of internalized technology transfer through FDI flows and in general, this type of technology transfer is very efficient mean of transferring a package of capital, skills, information, networks, and brand names to developing countries. For many technologies, internalised transfers are the only possible mode of transfer. Also, internalization may be the most efficient way of transferring the tacit knowledge involved and in the case of rapid technology changes. However, internalized technology transfer may also have some expenses. In general, the more standardized and diffused the technology and the more capable the buyer, the more economical will externalized modes be. A more subtle reason in favour of externalization concerns the existence of learning benefits, deepening and externalities. Costs of internalized technology transfer are especially expressed on the top level of technological capabilities where local innovative efforts become viable. At this stage, there is a case for restricting reliance of internalized forms to promote local R&D capabilities based on externalized forms, or for intervening in the FDI process to induce MNCs to transfer more advanced technological functions. We discuss the rationale for FDI policy and present the experience of Ireland and Singapore since these two countries have been highlighted for using the best-practice policies toward attracting FDI. Using benchmarking method we analyze FDI policy in Bosnia and Herzegovina.*

¹ It is important to mention that more open approach toward FDI is became necessity having in mind WTO rules and importance of technology transfer because they have maid almost impossible for developing countries to build up an industrial capacity behind closed doors.

² These studies are focusing on different level of analyses (country, sector or company) and they are different by the number of countries included in the analyses. For detailed review of the results of these researches see Te Velde (2003).

Introduction

Renewed confidence in the positive benefits of FDI to the economic development of the host country has led many countries to be more open towards FDI since the beginning of 1990s.³ As a result of increased liberalisation and technological advances, FDI flows rapidly increased during last few decades. FDI increased as a ration of domestic investment and GDP in many countries (UNCTAD, 2006a). However, while some countries attracted large FDI flows, others were less successful, even though they had liberalised FDI regimes.

A huge number of different studies on the impact of FDI on economic growth and productivity of domestic economy have been published.⁴ A general conclusion of these studies is that the benefits of the foreign companies in terms of economic development, even though they possesses a bundle of desirable assets (including a long-term external financing, new technology, skills, management practice and market access), and in general they are more productive, pay higher wages and are more export intensive than local firms, are by no means automatic. In addition, researches showed that FDI can also lead to some less desirable or undesirable outcomes such as rising inequality between individuals or groups of individuals in the society and between the regions, direct or indirect crowding-out of local capabilities or an erosion of the tax base or labour and environmental standards. Development of the local absorptive capacity (skills, R&D, infrastructure and etc.), according to those analyses, has a key importance in shaping the ultimate effect of FDI, suggesting an important role of complementary policy. Different programmes of encouraging linkages between TNCs and local firms, programmes supporting clusterisation and upgrading FDI are also approved as important.

This paper is organised as follows. The first section discusses the role of FDI in technology transfer, learning and competitiveness. Here we analyze benefits and costs of technology transfer through FDI flows and TNC subsidiary characteristics which enable them to contribute more to the national competitiveness of its host country. In the second section, we discuss the rationale for FDI policy and present the experience of Ireland and Singapore since these two countries have been highlighted for using the best-practice policies toward attracting FDI. In the third section of the paper, using benchmarking methodology, we analyze FDI policy in Bosnia and Herzegovina by comparing it with the experiences in the two countries. Finally, in the fourth section we draw conclusions and give some policy recommendations.

The Role of FID in Raising National Competitiveness

Global FDI flows are dominated by the multinational corporations (MNCs). MNCs are also the main source of innovation and innovation is often the main competitive factor that allows them to become and remain multinational (UNCTAD, 1999). As the major innovators, MNC are the main source of international technology transfer. Their role is naturally higher in high-technology activities where production and export grow much faster than the total world production and export (Lall, 2003).

In general, technology flows between the MNC affiliates (hereinafter: internalized technology flows) are very efficient means of transferring a package of capital, skills, information, and brand names to developing countries. For many technologies, internalised transfers are the only

³ It is important to mention that more open approach toward FDI is became necessity having in mind WTO rules and importance of technology transfer because they have maid almost impossible for developing countries to build up an industrial capacity behind closed doors.

⁴ These studies are focusing on different level of analyses (country, sector or company) and they are different by the number of countries included in the analyses. For detailed review of the results of these researches see Te Velde (2003).

possible mode of transfer, since innovators are unwilling to part with them to unrelated parties. Even where technologies are available at arm's length, internalization may be the most efficient way of transferring the tacit knowledge involved because of the commitment of transferor and its capability to support learning. If the technology is changing rapidly, internalization provides the most direct access to improvements. If the activity is export oriented, internalized transfers offer the additional advantages of international marketing skills and networks, established brand names or, of increasing relevance, access to integrated production structures spanning several countries.

However, internalized technology transfer may also have some expenses. Profits are realized by the MNC on the package as a whole rather than just the innovation component. If the host country already possesses other elements of the package, it is cheaper to buy the technology separately. In general, the more standardized and diffused the technology and the more capable the buyer, the more economical will externalized modes be. However, there is a more subtle reason: the existence of learning benefits, deepening and externalities may tilt the choice in favour of externalization even for relative complex and difficult technologies. In such activities, reliance on foreign investment can shorten the learning period but reduce the other benefits of technology transfer and capability building.

Costs of internalized technology transfer are especially expressed on the top level of technological capabilities where local innovative efforts become viable. On this level there can be a conflict of interest between the host country and foreign investor. There are good reasons for international investors to keep innovative work centralized at home or in a few developed countries; these include ease of coordination, skill availability, proximity to main markets, and more advanced science and technology infrastructures. At the same time, it is important for countries at a certain stage of industrial development do deepen their capabilities and move into the innovation led competitiveness phase, according to Porter's classifications.⁵ There is clear scope for a clash between the social interests of the host economy and the private interests of MNCs. At this stage, there is a case for restricting reliance of internalized forms to promote local R&D capabilities based on externalized forms, or for intervening in the FDI process to induce MNCs to transfer more advanced technological functions.

The above discussion also implies that TNK subsidiaries with a certain characteristics are able to contribute more to raising and sustaining national competitiveness of the host country. O'Donnell and Blumentritt (1999) point out the following: (1) the level in which the subsidiary has an active role in creating and implementing corporate strategy and the level in which it is a creator and user of the knowledge within company; (2) the type of industry, i.e. the level of technology which the subsidiary is using in its business processes; (3) the volume of the formal and informal training of the subsidiary's employees; (4) the degree to which the activities and outcomes of the foreign subsidiary affect or are affected by the activities of headquarters or other foreign subsidiaries. The subsidiary characteristics stressed here involve a high degree of knowledge and skills transfer from the parent company to its foreign location. In that way they impact innovative capability of the host country and its competitiveness. They also may have synergetic effect. A subsidiary that is both, high-tech or knowledge intensive as well as having a global mandate role will develop to an even greater extent the firm-level resources that contribute to national competitiveness.

Foreign Direct Investment Policy

As it was already mentioned, FDI flows continuously grow as well as their ratio in the total investments. However, while some countries managed to attract large FDI flows, others were less

⁵ For the detailed insight in the national competitiveness development phases see Porter (1990).

successful; even they had liberalized their FDI regimes. The objectives of FDI attraction differ by country (e.g. access to modern technology, market access, economic growth and poverty alleviation). Also, while some countries pay more attention to the quantity of flows, others change their policy focusing more to the quality of FDI. The term quality usually refers to FDI with a high value-added FDI and/or to FDI with positive linkages and spill-over effects for the domestic economy. Countries that have had successful development based on FDI continued with their activities on further FDI upgrading by encouraging the existing MNC affiliates to develop into strategic independents, or by targeting higher value-added FDI.

The key question economic policy makers in one country should discuss is how FDI can be incorporated in the country's development strategy. Since the implementation of FDI policies require financial resources (through up-front grants, promotion activities and institutional reform or through tax concessions) they should decide, if a such an option exist at all, if using FDI is more efficient and effective way of realising the objectives set in the development strategy. Finally, how much the country will rely on FDI in realising its objectives, and also which type of FDI is necessary with this respect.

With respect to FDI, the host country in general has to recognise and remove two specific market failures. The first one refers to the problem of missing information foreign investors are facing, and the other is the divergence in interest between mobile foreign investors and the host economy. Regarding the degree of the country intervention on removing these market failures, Lall (1995) identified four different approaches: (1) Passive open-door policy with limited policy interventions and no industrial policy, (2) Open door policy with selected to improve supply conditions, (3) Strategic targeting of FDI, and (4) Restrictive FDI policy. While options (1) and (4) are not sufficient to exploit opportunities for technological learning, the optimum for many low-income countries will be near the second approach and only if local capabilities develop a more strategic and targeted approach may produce better results.

Selection of the certain FDI policies should be followed by adequate implementation. The most successful are the countries that can follow FDI policies consistently and respond in a flexible manner to demands by potential investors. As a good and appropriate implementation of this policy can be mentioned Economic Development Board – EDB – Singapore or Ireland Development Agency – IDA.

Finally, it is important to point out that some World Trade Organisation agreements, such as Agreement on Conditions for Foreign Investments, which unable the member countries to use so called Trade-Related Investment Measures - TRIM, Agreement on Trade-Related Aspects of Intellectual Property Rights – TRIPS, and Agreement on Subsidies and Countervailing Measures – SCM, limit the options for the domestic FDI policy. However, the general assessment is that there is still some scope for creating the corresponding FDI policies and for their incorporating in development strategy of the country. It is more a question of whether a country desires or is able to conduct a proactive FDI policy.

FDI policy in Ireland and Singapore

In this part of the paper we present FDI experience of Ireland and Singapore. Both countries have been stressed for using best-practice policies towards attracting FDI. We first briefly present some data which highlight importance of FDI in these two economies, than we analyze the role played by policy in attracting and upgrading FDI and enhancing linkages between TNCs and local firms.

Ireland

Economic analysts agree that FDI has played an important role in transformation a largely agricultural Irish society into one of the fastest growing economies in Europe with one of the highest per capita GDP. FDI has created jobs in new sectors, raised investment and enhanced overall and local productivity. In 1995, foreign affiliates in Irish manufacturing accounted for 47.1 per cent of the total number of employees, 76.9 per cent of value added, 52.6 per cent of wages and salaries, 68.0 percent of R&D expenditure (in 1993), 82.3 per cent of exports and 77.8 per cent of imports (OECD, 1999). Value added per employee in foreign-owned firms was over 60 per cent higher than in domestic firms. Barrel and te Velde (1999) estimate the impact of FDI on overall technical progress and find it to be significant and positive.

Visible influence of FDI on Irish economy has resulted in huge number of papers that stress importance of different factors in attracting FDI, starting from industrial (Ruane and Gorg, 1999) and macroeconomic policy (Fitz Gerald, 2000), but also some other factors (Ruane and Gorg, 1999) such as its location. Some papers also put attention to policies for upgrading FDI and to make linkages between TNCs and local firms (O'Malley, 1998).

Industrial policy towards FDI has been implemented by IDA. Initially a part of the Department of Industry and Commerce with powers to issue grants that covered the costs of land and buildings, IDA was established as a separate state agency in 1969 with the responsibility for national industrial development. IDA expanded quickly in terms of staff (230 initially) and location of operation with IDA staff operating worldwide. IDA targeted aggressively and firm-specifically involving telephone calls, presentations, provision of research, visits and other meetings. The IDA identified electronics and pharmaceuticals companies from the US as offering the best opportunities for FDI led industrialisation.⁶

The IDA was also able to award grants to firms covering part of their initial capital expenditure and these were later coupled to employment generation.⁷ IDA expenditure per job decreased from over IR 35,000 in the period 1981-1987 to IR 10,000 over 1993-1999. Total expenditure of IDA Ireland in 1999 amounted to IR 160 million, with IR 129 million paid in grants and IR 21 million paid towards promotion and administration, of which IR 5 million towards marketing, consultancy, promotion and advertising (IDA, 2000).

Fiscal incentives have been perhaps more important in attracting FDI (Ruane and Gorg, 1999). There was a fifteen-year (zero) tax holiday on profits from new export profits from the 1950s, which changed into a 10 per cent corporate tax to all new firms (compared to around a standard 50 per cent corporate tax rate by that time) from 1982 to be consistent with EU rules. Under further international pressure Ireland is now committed to a 12.5 per cent corporation income tax for all firms from 2003, with some concessions until 2010. Thanks to these fiscal incentives and specific targeting, the IDA was in the position to develop key export-intensive sectors (electronics and pharmaceuticals) leading to band-wagon and agglomeration effects.

While specific industrial policies have been very important in attracting FDI, there are also macroeconomic policies and other important factors without which it would have been difficult to attract FDI. The government has consistently followed a policy of skill-upgrading by providing education (Fitz Gerald, 2000). The availability of skills further improved recently through net immigration of Irish and other nationals. While the physical infrastructure was initially neglected

⁶ These sectors now form the basis of industrial clusters. In 1999, 15 per cent of employment in foreign companies (IDA supported) was in pharmaceuticals/healthcare and 49 percent in electronics/engineering.

⁷ Nowadays, these grants must be consistent with EU rules on state aid which means that they are still allowed only in low-income regions.

until the late 1980s, EU structural funds (6 per cent of GDP in early 1990s) have helped to develop the infrastructure since then. IDA Ireland also develops land and industrial parks for foreign investors.

Other important factors have been strong historical ties with the US, which helped to attract US investment, the use of the English as the official language and more recently the boom in the US and electronics sector.

Last but certainly not least, the opening-up of the Irish market, first with signing Anglo-Irish Free Trade Agreement in 1965 and then EU membership in 1973, combined with proximity to the huge EU market has been of crucial importance for the development of Ireland as an export platform to the EU. However, we must notice that Portugal and Greece are also close to the EU, but have been less successful in attracting FDI. Economic (as opposed to geographical) distance becomes more important as transportation costs fall and the 'weightless' economy gains in importance.

Up to early 1990s, Ireland focused more on attracting quality FDI rather than on upgrading existing FDI. Firms in high-value added sectors were targeted (e.g. through higher grants) more because they added new, high-value exports, rather than because they could link in with (non)existing local manufacturing capabilities. From the early 1990s there was also concern about developing affiliates (as 'strategic independents'), focusing on raising the level of R&D in foreign and also domestic firms. While business R&D as a percentage of GDP has been rising from 0.7 in 1981 to 1.4 per cent in 1997, it is rather low according to the international standards (OECD, 1999).

While attracting export-intensive TNCs ensures fewer fears of crowding-out of domestic operations, there was considerable concern that the economic distance between local and foreign firms was too great to lead to significant spillovers and linkages. As a reaction to this National Linkage a Programme has been launched. The aim of this programme was to improve organisational and marketing skills as well as quality and productivity of local firms to bring it up to the standard required by TNCs. TNCs helped to upgrade local suppliers by providing technical know-how. Partly as a result of the NLP, but also because TNCs were present in the market for a longer time, Irish raw material purchases rose between 1988 and 1998, from 15.4 per cent to 21 per cent in non-food manufacturing and from 13.2 to 22.8 per cent in electronics (Ruane and Gorg, 1998). A key strategy for developing local capabilities was to develop sub-supply industries along the value-added chain, not only for supply of TNCs in Ireland but also to be able to compete internationally, thereby also reducing the dependence on TNCs.

Singapore

There are many stories about Singapore's remarkable development path and the role that FDI has played⁸ Singapore developed from a struggling low-income colony in 1960s to a modern and developed high-tech country. GDP growth rates have continued to be 10 per cent on average over the past fourth decades. At the same time, the accumulated stock of FDI as a percentage of GDP has risen from 5.3 per cent in 1965 to 98.4 per cent in 1998 (Yeung, 2001). In 1997/1998, foreign firms employed 50.5 per cent of workers in manufacturing, 29.1 per cent in trade and 25.7 per cent in finance.

Singapore became independent after two-year stint with Malaysia failed in 1965. Singapore, though traditionally an important trading port, was now isolated from its hinter-land, as Indonesia refused to import goods and Malaysia wanted to cut out the middle-man Singapore in its trading activities. Singapore also lacked natural resources and entrepreneurial business elite. Further, there

⁸ For the detailed insight in the FDI policy in Singapore see Lall (2000).

was the impending withdrawal of the British armed forces, which contributed an estimated 20 per cent to the economy. All these made an import-substitution strategy virtually impossible. Singapore had no policy option but to industrialise relying on TNCs bringing their expertise and technologies.

Singapore's industrial strategy was partly based on a 1960 UNDP study on the future of Singapore. This study recommended the establishment of Economic Development Board (EDB) to be responsible for industrialisation of Singapore. The EDB was founded in 1961 as one-stop agency with a budget of around US\$ 25 million (over 4 per cent of GDP). In the beginning of its work EDB was focusing on ship repair, metal engineering, chemicals and electrical equipment and appliances.

The EDB has acted proactively (developing sites, seeking promotion) and responded to market forces ever since it began operations. The EDB's aim was to promote industries (mainly foreign after 1965) in Singapore and begun to build up offices abroad. It had four divisions: investment promotion, finance, projects and technical consultant service and industrial facilities. It was set up as an autonomous government agency, which could set its own wages, had a board comprising business and other agencies, and had an international advisory board comprising executives of major foreign companies located in Singapore. While in the initial stages the notion of a one-stop centre was helpful to attract FDI, the operations became more complex over time and resulted in the specialisation towards FDI promotion while other activities were left to other agencies. The EDB has maintained close links with those new agencies ever since and still acts as a one-stop service.

The EDB decided to spend a significant share of allocated funds on the development of the Jurong Industrial Estate. An uncultivated piece of land was quickly transformed into an industrial estate with adequate infrastructure and factories and a new port was built. However, the estate was unsuccessful in the early years and with only twelve pioneering firms in 1961, it had slow start (activity remained sluggish until 1965). The EDB had invested vast sums in joint ventures, some of which had failed. Nevertheless, there have never been real doubts about the FDI-led industrialisation opposite to other developing countries' view that TNCs only exploit developing countries.

The industrial strategy proved to be successful by the late 1960s and early 1970s and was able to reduce unemployment rate fairly quickly. Whilst employment generation was a major focus of policy in the 1960s and early 1970s, this shifted to capital-intensive projects in the 1980s, and knowledge-intensive sectors in the 1990s. The incentive structure is complex and has developed over time. A significant incentive was the Pioneer Industries Ordinance of 1959, with firms exempted (or significantly reduced) from the 40 per cent corporate tax for a fixed period of time provided that firms developed new products. As the result the share of manufacturing output for firms with pioneer status increased from 7% in 1961 to 51.1% in 1971 and 69% in 1996. Another important tax incentive was the reduction the corporation tax for capital-intensive industries that suppose to replace labour-intensive industries.

Over time wages rose, especially in the period 1985-1986, when the country faced first post-war recession. It was obvious that Singapore could only cope with rising wages in local firms developed capabilities (technical and human resources) and if TNCs continued to upgrade (using R&D incentives, incentives to set-up high skilled head quarters and encouraging joint research institutes through government funding). Special programme has been launched in 1986, under which TNCs were encouraged to enter into long-term supply contracts with local firms, leading to upgrading. The EDB began to target knowledge-intensive industries that could pay higher wages.

As part of a number of relevant skill-upgrading schemes (Lall, 1996), the PSB is responsible for the Skill Development Fund. Set up in 1979, it imposed levy on the payroll on employers for

every worker earning less than a pre-determined amount. It is an efficient way to enhance within-firm skill upgrading of unskilled workers because firms themselves do not have sufficient incentives to do so.

More recently, the EDB has followed a cluster approach, targeting firms around the electronics/semi-conductor, petrochemicals and engineering industries.⁹ The cluster approach also leads to enhanced linkages and spillovers to the local economy. Government further enhances the value of the cluster through investment in R&D centres.

While the above indicates a strong role for industrial policy, macroeconomic policies have also played a role. Infrastructure has been built with regard to the needs of TNCs. Trade policies have always been very liberal with very low tariff and thanks to an increase in ISO certificates also low non-tariff trade barriers. Besides training, general education has also been important (Lall, 1996).

However, there are also some external factors, which have shaped policies towards FDI or have been important in attracting FDI, and which may take the case of Singapore less general in its application to other countries. Singapore is a city-state with a relatively authoritarian state that can formulate policies without much resistance from either other levels of government, or from civil society. Further, Singapore never runs government deficits, which is helpful to find capital for (profitable) investment (in part financed out of a high statutory pension levy). Perhaps another factor for attracting FDI is that the working language is English. Further, the location in the time zone enabled financial services to fill the gap between the US and Europe during the 24-hour day.

Bosnia and Herzegovina

Since the declaration of independence from the former Yugoslavia in the beginning of 1992, Bosnia and Herzegovina suffered from a conflict for more than three years. According to Dayton Peace Agreement, which is signed in 1995, Bosnia and Herzegovina was to remain a single State comprising two constituent entities – the Federation of Bosnia and Herzegovina, and the Republika Srpska. In the post-war period economic reconstruction was at the centre stage of activities and transition to a market economy was to be enhanced.

Table 1: B&H main economic indicators

Indicators	2003	2004	2005
Nominal GDP (million EUR)	6,812	7,495	8,052
GDP per capita (EUR)	1,778	1,950	2,095
Real GDP growth rate (%)	3.0	6.0	5.5
Annual inflation rate (%)	0.6	0.4	3.7
Annual unemployment rate (%)	42.0	43.2	31.1*
Trade balance (million EUR)	-3.035	-3.227	-3.781
Inward FDI (million EUR)	*	534	421

* Revised estimates based upon the annual Labour Force Survey carried out for the first time in April 2006

Source: Statistical Agency of B&H; Central Bank of B&H

Bosnia and Herzegovina has relatively stable macroeconomic climate, characterised by sustained economic growth, stable currency and low inflation (See Table 1). In 2005, nominal GDP reached 8.05 billion EUR. Real growth was 5.5 per cent, continuing the underlying trend of growth of around 5.5 – 6 per cent. The Central Bank of Bosnia and Herzegovina (CBBH) that started its

⁹ The EDB began an S\$ 1 billion Cluster Development Program in 1994, and has recently tripled in size.

operations in August 1997, pegged its currency (the convertible marka) first against the German mark and later the euro through the Currency Board System.¹⁰ Average inflation rate is the lowest in SEE region. B&H has a liberal trade regime with average tariff rate of 6 percent, the lowest in SEE after Croatia. BH has also signed Free Trade Agreements with all SEE countries.

The other side of the economic situation in B&H is as follows. The real GDP in 2005 was only 63 percent relative to one from 1989, which is much lower comparing to transition countries average (EBRD, 2005). Unemployment rate is incredible high. A liberal trade policy compound with the lack of international competitiveness resulted in huge trade deficit. Export to import coverage has been slightly growing in last few years but still is less than 40 per cent. Current account deficit in 2004 was about 17 percent relative to GDP (World Bank, p. 24). B&H's revealed comparative advantage in EU markets is concentrated in products with low level of processing. In addition, BH exports to the EU are heavily concentrated in natural resources-based and unskilled labour-intensive products. Resources-based products the dominant category, accounting for 45 percent of EU-bound exports in 2002, while the unskilled labour-intensive products accounts for the 42 percent. Unlike experiences in other CEECs, BH witnessed limited restructuring in factor intensities of its exports. Combined share of skilled labour-intensive and capital-intensive products in EU-destined sales remained virtually unchanged at about 13 percent over 1997-2003 period (World Bank, 2005, p. 36-37).

The enterprise sector of B&H is poorly integrated into international production and distribution networks. Firms in B&H are primarily inward-oriented. For example, over 63 percent of the surveyed firms in BEEPS2 relied on foreign sources for their supplies of material input. At the same time, export receipts were 10.6 percent of sales revenue in 2002, a number lower than the SEE8 regional average of 12.5 percent. Only surveyed firms in Serbia and Montenegro reported weaker export intensity among the eight SEE countries. Surveyed firms in B&H also fared worse than the average SEE firm regarding their activities in new international markets. Every fifth surveyed SEE firm exported to new markets between 1998 and 2002, while only 6.6 percent of the surveyed firms in BH had reached new foreign customers during the same period. The reaching of new markets by BH companies between 1998 and 2002 is similar to the international expansion of firms in Albania and SAM, but considerably lower than that of firms from Romania and Bulgaria (Broadman et. al., 2004).

FDI policy in Bosnia and Herzegovina

After the 1992-1995 war, foreign nationals are encouraged to invest in the country and to take part in the privatization process. Foreign ownership is generally unrestricted, except in a few sectors where it is limited to 49 per cent of the legal capital. Under the 1998 Law on Foreign Direct Investment Policy, foreign investors are given national treatment, and enjoy the same rights (including property rights) and obligations as local investors. They are free to transfer profits abroad and to repatriate funds related to their investments. No performance requirements are imposed as a condition for establishing an investment. Protection against expropriation is available. Guarantee is given to investors, in the event of a change in legislation, to choose to be subject to the law that is favourable to them. Moreover, in the event of civil unrest arising from political disturbance, protection against loss incurred by foreign investors is offered by the Investment Guarantee Agency, a state body, and backed by the ING Bank of Netherlands.

The Foreign Investment Promotion Agency (FIPA), a state body established in July 1999 by the Council of Ministers, is responsible for promoting and attracting foreign investment. With links at various levels of Government and industry, it provides information on legislation and investment

¹⁰ Convertible mark is pegged to the Euro at a fixed exchange rate of KM1 = Euro 0.51129.

opportunities to potential investors, and assists them to establish joint ventures or greenfield operations.

Bosnia and Herzegovina enhances its attraction for FDI in authorizing duty-free imports of capital goods that contribute to the capital base of a foreign-invested enterprise. As the country's taxation rate is under the jurisdiction of each entity, investment incentives offered may vary between the Federation of Bosnia and Herzegovina, and the Republika Srpska. The rate of corporate income tax is 30 per cent in the Federation of Bosnia. The Federation Law on Corporate Income tax provides that the corporate income tax is reduced for a period of 5 years equal to the percentage of foreign capital invested in the assets of the company, provided that the foreign capital is greater than 20 per cent of total capital. This incentive includes companies with 100 per cent foreign capital investment. The rate of corporate income tax is invariably 10 per cent in the Republika Srpska. Bosnia and Herzegovina introduced VAT on the 1st January 2006 at a flat rate of 17 per cent on all goods and services and it is collected on the state level.

Access to any of the nine Free Trade Zones (FTZs) is possible to both local and foreign investors, where most activities may be performed. Additional benefits are granted to firms operating within a FTZ boundary. Goods manufactured or transformed in the zone may also be sold in the local market, after payment of duties and taxes on imported items. No taxes and contributions are levied, except on salaries paid. Transactions within an FTZ may be expressed in any foreign currency and investors are permitted to open foreign-exchange accounts in authorized banks.

Table 2: Inward FDI in SEE region

FDI flows	<i>In million of dollars</i>				<i>As % of gross capital formation</i>			
	1990-2000 (average)	2003	2004	2005	1990-2000 (average)	2003	2004	2005
Albania	63	178	332	260	21.1	13.5	18.5	13.8
B&H	78	381	606	298	7.8	26.4	34.1	16.0
Bulgaria	301	2,097	3,443	2,223	18.1	54.3	68.1	35.1
Croatia	544	2,133	1,262	1,695	13.1	25.2	12.5	15.4
FYR, Macedonia	59	95	157	100	9.7	12.2	15.9	9.7
Romania	656	2,213	6,517	6,388	9.4	17.4	39.9	28.1
Serbia and Mont.	165	1360	966	1481	13.4	44.9	24.4	35.8
Slovenia	139	333	827	496	3.6	5.1	10.6	5.9

Source: UNCTAD (2006b)

Despite all the above efforts FDI inflows in B&H are among the lowest in SEE region (See Table 2). What is maybe more important, according to the World Economic Forum Estimates (2006), FDI contribution to B&H technological upgrading, export and competitiveness is rather low.

Comparison of B&H with Ireland and Singapore

Here we will make some interesting comparisons between FDI policy in B&H experiences in Ireland and Singapore.

- o As we saw in the second section of the paper both countries, Ireland and Singapore, had an aggressive one-stop agency with ample political power to swing policies towards foreign investment. Foreign Investment Promotion Agency in B&H has no political power. It has around twenty employees. Because of relatively low salaries FIPA

is facing problem of frequent fluctuations of its stuff. In last few years its budget has not been changing and it around 1,5 million of KM.

- Ireland and Singapore followed a pro-FDI policy consistently and had a strong proactive industrial policy approach (perhaps not always explicit in policy documents) with fiscal incentives and grants. FIPA does not have the strategy of FDI promotion. Every foreign investor is treated equally. It does not matter from which industry it comes, what kind of technology it brings, or is it export oriented or not. B&H has applied passive open-door policy with limited policy interventions and no industrial policy, according to the Lall (1995) classification.
- Both countries realised that local capabilities did not develop sufficiently, and put in place linkage programmes between TNCs and local firms. FIPA nor any other political entity in B&H do not even analyze the issue of potential gaps between TNCs and the local economy. It is left to the market forces.
- Both countries launched programmes of upgrading established foreign investors to solve the problem of rising factor prices. In B&H there is no political entity which is authorised for following activities or launching programs directed toward existing foreign investors.
- What is maybe the most important is that in the case of both countries FDI policy was clearly fitted in with their development strategies. In this way they were able to develop integrated FDI policies. They have used both macroeconomic and industrial policies and they have used them to attract FDI, upgrade existing FDI and to enhance linkages and spillovers to domestic firms.¹¹

Conclusions and policy recommendations

Based upon renewed confidence the positive effects associated with FDI many developing countries are increasingly looking for best-practice policies towards FDI. Whilst FDI can bring positive effects (technology, finance, market access or brand names), it can also bring negative effects. Moreover, the positive effects are not automatic for host countries and depend on many other policies and external factors.

Importance of different policies depends on the specific country characteristics, the objective of the country and the derived FDI strategy. However, we can identify some common elements. In each country FDI policy should fit in with a country's development strategy. Also, FDI policies are likely to be some combination of different policies. Macroeconomic policies, as we saw in the case of Ireland and Singapore, are often combined with specific industrial policies. Both of them are used for affecting the location decision of foreign investors, affecting upgrading established foreign investors and affecting linkages and spillovers to domestic firms. Realising that FDI policy should comprise policies in each of these categories is a positive step towards enhancing the benefits of FDI.

Analyzing FDI policy in Bosnia and Herzegovina and comparing it with the experience some other successful countries we can point out some broad policy recommendations:

- First of all, B&H has to fit in its FDI policy with its development strategy;
- It has to work more on building local capabilities (R&D, education etc.) and infrastructure to establish economic fundamentals to attract FDI and benefit from FDI;

¹¹ Both of these countries had favorable external factors, but according to here reviewed studies they were not decisive in attracting FDI.

- It is needed to start target specific firms that fit into development strategy which can be coordinated by a true one-stop investment promotion agency, with more political power and resources (human and financial);
- FIPA or some other political entity has to put in place linkage programmes between TNCs and local firms and programmes of upgrading established foreign investors to solve the problem of rising factor prices.

Literature

1. Barrell, R. And te Velde, D.W. (1999): 'Labour Productivity and Convergence Within Europe: East German & Irish Experience', NIESR Discussion Paper 157
2. Broadman, H., Anderson, J., Claessenes, C., Ryterman, R., Slavova, S., Vagliasindi, M., and Vincellete, G. (2004): *Building Market Institutions in South Eastern Europe: Comparative Prospects for Investment and Private Sector Development*, Washington, DC: World Bank
3. CBBH (2006): 'Annual Report for Year 2005', Central Bank of Bosnia and Herzegovina, http://cbbh.ba/statbilten/bilten_3_2006.zip [Accessed 11.01.2007]
4. FIPA (2006): 'General Economic Indicators', Foreign Investment Promotion Agency, <http://www.fipa.gov.ba/FipaFiles/File/Publications/Fact-sheets/FIPA%20FS%20Economy.pdf>[Accessed 12.01.2007]
5. FIPA (2006): 'Investment-Related Law Compendim', Foreign Investment Promotion Agency, <http://www.fipa.gov.ba/FipaFiles/File/Publications/Fact-sheets/FIPA%20FS%20Economy.pdf>[Accessed 12.01.2007]
6. Fitz Gerald, J. (2000): 'Ireland's Failure – and Belated Convergence', The Economic and Social Research Institute, Research Paper, September 2000
7. IDA (2000): 'IDA Annual Report', USC Center for Law, Ida Ireland, <http://www.idaireland.com/uploads/reports/annu00/index.html> [Accessed 15.12.2006]
8. Lall, S. (1995): 'Industrial Strategy and Policies on Foreign Direct Investment in East Asia', *Transnational Corporations* (4(3)): 1-26
9. Lall, S. (1996): *Learning from the Asian Tigers*, London: Macmillan Press
10. Lall, S. (200): 'Export Performance, Technological Upgrading and Foreign Direct Investment Strategies in the Asian Newly Industrializing Economies – With special reference to Singapur', ECLAC seriw desarrollo productivo 88, Santiago, Chile
11. Lall, S. (2003): 'Foreign Direct Investment, technology development and competitiveness: issues and evidence', in S. Lall and S. Urata, ed.: *Competitiveness, FDI and Technological Activity in East Asia*, Northampton: Edward Elgar Publishing, pp. 12-56
12. OECD (1999): *Activities of Foreign Multinationals*, Paris: OECD
13. O'Donnell, S. and Blumentritt, T. (1999): 'The Contribution of foreign subsidiaries to host country national competitiveness', *Journal of International Management* (Volume 5): 187-206.
14. O'Malley, (1998): 'The revival of Irish Indigenous Industry 1987-1997', Yuarterly Economic Commentary, ESRI
15. Porter, M. (1990): *The Competitive Advantage of Nations*, London: Macmillan Press
16. Ruane, F. and Gorg H. (1998): 'Linkages Between Multinationals and Indigenous Firms: Evidence for the Electronics Sctor in Ireland', Trinity Economic Papers Series, 98/13
17. Ruane, F. and Gorg H. (1999): 'Irish FDI Policy and Investment from the EU', in R. Barell and N. Pain, ed.: *Investment, Innovation and the Diffusion of technology in Europe*, London: Cambridge University Press, pp. 4767
18. Te Velde, D.W. (2003): 'Government Policies towards Foreign Direct Investment', in G. Wignaraja, ed.: *Competitiveness Strategy in Developing Countries*, London: Routledge Studies in Development Economics, pp. 166-197
19. UNCTAD (1999): *World Investment Report*, Geneva: UNCTAD
20. UNCTAD (2006a): *World Investment Report*, Geneva: UNCTADva

21. UNCTAD (2006b): 'World Investment Report 2006' United Nation Conference on Trade and Development, http://www.unctad.org/en/docs/wir2006_en.pdf [Accessed 12.01.2007]
22. UNCTAD (2006): 'World Investment Report 2006 – Country Fact Sheet' United Nation Conference on Trade and Development, <http://www.unctad.org/img/common/pdf.gif> [Accessed 12.01.2007]
23. Yeung, H.W-C. (2001): *Entrepreneurship and the Internationalisation of Asian firms: An Institutional Perspective*, Cheltenham: Edward Elgar
24. World Economic Forum (2004): *The Global Competitiveness Report 2004-2005*, New York: Oxford University Press.
25. World Bank (2005): *Economic Memorandum for Bosnia and Herzegovina*, Sarajevo: World Bank