A business-friendly regulatory environment and political stability are the top two factors influencing multinational companies’ investment decisions in developing countries, based on a survey of 750 business executives? These two factors top over characteristics, including good infrastructure, access to land, and low tax rates.

FDI from developing countries has increased 20-fold in the last 20 years, accounting for nearly 20% of global FDI flows in 2015.

9 out of 10 developing countries have companies that have established overseas affiliates.
The fastest growing firms in developing countries are usually small and young, yet they benefit from FDI more than other firms.

Developing countries have made tax holidays and other fiscal incentives to investors more generous over the last decade; yet such incentives influence location decisions of only some types of investors, such as efficiency-seeking companies.

While investment in fragile and conflict-affected states is generally low, data suggests higher-than-realized investment potential, as well as dramatic FDI booms during re-construction especially in sectors such as construction, transport, storage, communications and other services sectors.
MOTIVATIONS

This inaugural issue of the World Bank Group’s Global Investment Competitiveness Report presents novel analytical insights and empirical evidence on foreign direct investment’s (FDI), focusing on developing countries and FDI’s potential benefits for inclusive and sustainable development.
Three key features distinguish this report from other leading FDI studies.

The report features a **ground-breaking survey of more than 750 executives of multinational corporations**, in addition to extensive analysis of available data and evidence, and a thorough review of international best practices in investment policy design and implementation.

The report provides targeted, in-depth analysis of FDI **differentiated by motivation, sector, and geographic origin and destination of investment**.

The report offers **practical and actionable recommendations** to developing country governments.

Overall, the report finds that a **favorable business environment is key to attracting and retaining FDI in order to realize economic transformation and economic growth**.
FDI IS GOOD FOR DEVELOPMENT

The benefits of FDI in developing countries extend beyond capital, providing productivity gains in the form of:

- Technical know-how
- Knowledge, managerial and organizational skills
- Access to foreign markets
- Increased competition and productivity in local markets
- Positive spillovers to local firms

FDI flows into developing countries are:

1. **SIGNIFICANT:**
   FDI is the largest source of external finance for many developing countries, surpassing official development assistance, remittances and portfolio flows

2. **SUBSTANTIAL**
   In 2016, more than 40 percent of the global $1.75 trillion FDI flows were directed to developing countries

   More than a third of investors re-invest all of their profits into the host country. Investors value policies that help them expand their business more than just policies used by governments to attract them.
FDI flows into developing countries are:

3. STILL SCARCE:
Private investment provides but a fraction of what is needed to meet Sustainable Development Goals.

FDI into fragile and conflict-affected situations (FCS) represents just 1 percent of global flows, more than five times less per capita than the world average.
FDI BENEFITS HOST ECONOMIES

High-growth firms in developing countries benefit the most from FDI

Local firms with the highest job creation rates – i.e. the high-growth firms – are the ones who benefit most from FDI presence in their markets.

These benefits are transmitted from FDI to local high-growth firms through 2 channels:
• Linkages: Contracts between FDI and local suppliers and subcontractors
• Demonstration effect: Adoption of foreign firms’ technologies and management practices by local high-growth firms

Why? High-growth firms, when compared to other local firms, are better able to assimilate new information, internalizing foreign technologies and improving their productivity. They have higher absorptive capacity.

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Governments can strengthen development results by targeting high-growth firms with FDI linkage policies and other business development programs.

A 1 percentage point increase in the share of inputs purchased by a foreign firm from local companies is associated with a 58% increase in sales of a typical high-growth local company over 2 years.

\[ +1\% = 58\% \]

- Share of inputs purchased
- Increase in sales of a typical high-growth local company over 2 years

A 1 percentage point increase in the share of total economic output attributable to foreign firms is associated with a 12% increase in sales of a typical high-growth local company over 2 years.

\[ +1\% = 12\% \]

- Share of total economy's output
- Increase in sales of a typical high-growth local company over 2 years
FDI ALSO BENEFITS HOME ECONOMIES

Outward FDI from developing countries benefits their source economies

Outward FDI by companies from developing countries can strengthen domestic competitiveness by:

- Acquiring new technologies abroad, including patents, technological know-how, cutting-edge processes, thus strengthening their capabilities and competitiveness
- Driving innovation at home
- Importing intermediate inputs from their own affiliates at lower prices

Developed countries were once the prime source of knowledge and technology, but South–South and South–North innovation-oriented collaboration is on the rise.

- Knowledge originating in developing countries may be better suited to other developing country settings
- Certain levels of complexity may be more easily absorbed by economies at similar levels of development

Host economies must fully understand the type of FDI received and respond with a nuanced policy responses

- Should encourages firms to root investment, expand operations and link into the local economy
- Benefits of FDI can be strongly magnified in economies with good governance, well-functioning institutions, and transparent and predictable legal environments
Despite these potential benefits, many developing countries continue to restrict outward FDI flows.
DEVELOPING COUNTRIES ARE AN INCREASING SOURCE OF FDI

FDI from developing countries has increased twentyfold in the last two decades, accounting for nearly one-fifth of global FDI flows in 2015. This is because:

- Rapid, sustained growth in much of the developing world helped firms prosper and internationalize.
- Until recently, commodity super-cycles gave some developing country exporters created substantial liquidity which financed OFDI.
The largest developing markets – BRICS – account for 75% of these flows. China in particular has moved from owning 12% of global FDI stock in 1995 to 36% in 2015.

Yet it is a wide-spread phenomenon: 9 out of 10 developing countries have companies that have established overseas affiliates.

In 2001, only 11 out of nearly 140 developing countries had half or more of their inward FDI stock coming from investors from other developing countries. In 2012, 55 developing countries — a 5-fold increase — did. This is particularly true for least developed countries.

Contribution of Southern MNCs to economic development of emerging markets is significant, especially given low investor confidence prevailing today among traditional Northern MNCs.
DEVELOPING COUNTRY INVESTORS ARE MORE WILLING TO TARGET HIGHER-RISK LOCATIONS

Investors from developing countries – and particularly intra-regional investors -- are more willing to target higher-risk markets in host economies with weaker institutional quality.

- Investors from developing countries may have an “institutional advantage” in which their experience makes them more adept in operating within weak institutional environments.

Such first-movers and pioneers can help host-country governments develop regulations and support services, establish business and consumer markets, and generate positive externalities.

They also offer a demonstration effect to other investors that the target countries and markets are open to financially viable investments despite high risk perceptions.

Opportunity — Over 1 billion people are currently living in fragile and conflict territories. By 2030, half of the world’s poor will be living in FCS.

www.worldbank.org/gicreport
Overall, investors are more cautious when entering FCS markets—committing to smaller projects in relatively stable areas.

FDI in FCS represents a mere 1 percent of global flows. Despite having increased tenfold over the last two decades, FDI directed to FCS is mostly concentrated in a handful of middle-income or resource-rich economies. Agriculture remains vital source of income and employment for poor and conflict-affected populations with share that reach over 50% of formal activity in a number of FCS.

FDI in FCS is concentrated in capital-intensive (e.g. extractives) and export-oriented sectors. Focus on non-labor-intensive sectors results in FDI in FCS producing fewer jobs per dollar invested than FDI in other developing countries.
INVESTMENT DECISIONS ARE INFLUENCED BY RISK/RETURN CALCULATIONS

Investors consider various factors when investing. These include: domestic market size, macroeconomic stability and a favorable exchange rate, labor force talent and skills, and physical infrastructure. The two most important factors are:

- **Political stability and security**
- **Business-friendly regulatory environment.**

86 percent of investors find the business environment important or critically important.

Regulatory predictability and efficiency lower risk, and are viewed as critical elements of the business environment.

<table>
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<tr>
<th>Country Characteristics</th>
<th>Critically important</th>
<th>Important</th>
<th>Somewhat important</th>
<th>Not at all important</th>
<th>Don't know</th>
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<tr>
<td>Political stability and security</td>
<td>50</td>
<td>37</td>
<td>9</td>
<td>2</td>
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<tr>
<td>Legal and regulatory environment</td>
<td>40</td>
<td>46</td>
<td>12</td>
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<td>38</td>
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<tr>
<td>Macroeconomic stability and favorable exchange rate</td>
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<td>44</td>
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<tr>
<td>Good physical infrastructure</td>
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<td>46</td>
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<td>5</td>
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<tr>
<td>Low tax rates</td>
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<td>39</td>
<td>31</td>
<td>9</td>
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<tr>
<td>Low cost of labor and inputs</td>
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</tbody>
</table>
Yet not all investors are the same. Investors involved in export-oriented efficiency seeking FDI look for internationally cost-competitive destinations and potential export platforms value linkages, incentives, trade agreements and IPA services more than other investors.

Incentives such as tax holidays are important for 64 percent of investors involved in efficiency-seeking FDI, compared to only 47 percent of their counterparts involved in other types of FDI. Investment Promotion Agency services are rated important by about half of the investors involved in efficiency-seeking investment, but only about a third of non-efficiency-seeking ones.

Almost two-thirds of investors selected multiple motivations—when asked about which motivation prevails, most investors (71 percent) say they are market-seeking.
To attract investments governments must de-risk investment climates by lowering political risk and increasing predictability.

Over 90% of all investors rate various types of legal protections as important or critically important, the highest response among all factors asked in the survey. These guarantees include the ability to transfer currency in and out of the country, existence of legal protections against expropriation, against breach of contract, and against non-transparent or arbitrary government conduct.

Three-quarters of investors have experienced disruptions in their operations due to political risk forces and events that have caused about a quarter of investors to cancel or withdraw an investment.
For close to 30% of investors that have experienced closing down an affiliate in a developing country, some reasons for exiting the investment could have been avoidable, such as unstable macroeconomic conditions and increased policy and regulatory uncertainty.

Severe cases such as breach of contract and expropriation occur fairly infrequently, about 13% and 5% respectively, but when they do, the negative impact is strong. In cases of breach of contract over a third cancel or withdraw investments, and for expropriation, almost half do so.

Losing an existing investment can have long-term, debilitating impacts on a developing country, especially by alarming prospective investors.
TAX INCENTIVES OFTEN DO NOT INFLUENCE RISK/RETURN CALCULATION

Investment incentives are a popular investment attraction tool, but are not enough on their own.

Incentives are not only widespread, but also increasing. The use of incentives is increasing: 46 percent of LMICs introduced new incentives or made existing incentives more generous for at least one sector between 2009 and 2015.

Yet incentives do not appear to have a stronger influence on new investors than on previously existing ones, calling into questions their targeting towards new investment.

Transparent administration can reduce indirect, unintended costs of incentives, including economic distortions, red tape, and corruption.

Moving from profit-based instruments such as tax holidays and preferential rates to cost-based incentives such as an investment allowance that are more results based, predictable in their fiscal outcome, and less prone to abuse.
Incentives are most relevant for efficiency-seeking FDI. Incentives such as tax holidays are important for 64 percent of efficiency-seeking investors, compared to only 47 percent of their non-efficiency-seeking counterparts. For predominantly efficiency seeking sectors, FDI projects are clustered in a limited number of highly competitive host countries, and at the same time these sectors show the highest prevalence of incentives. On the other hand, projects in extractives and financial services are among the most dispersed geographically, and receive the lowest share of incentives.

Source: Computation based on Developing Country Tax Incentives Database and FDI data from fDi Markets database, the Financial Times.
Note: The size of each bubble represents the number of FDI projects within the sector in developing countries. This was constructed based on information from the fDi Markets database. CIT = corporate income tax; FDI = foreign direct investment; IT = information technology.
MAIN MESSAGES FOR DEVELOPING COUNTRY POLICY MAKERS

Enhance country’s investment competitiveness. Increasing investment competitiveness requires creating an enabling and predictable environment to attract and retain FDI, as well as maximizing its benefits for development, including strengthening of the domestic private sector. The growing trend of inward and outward FDI from developing countries creates new opportunities for improving country’s investment competitiveness.

Target reforms along the investment lifecycle and depending on the motivation of the investor. GIC report presents specific opportunities for reforms at various phases of the cycle of an investment (entry, growth, exist). Policy instruments, such as investment incentives, play a different role depending on the motivation of investment, distinguishing between efficiency-seeking, market-seeking, or natural-resource seeking FDI.
De-risk business environments to reduce uncertainty and unpredictability. Lowering investor risk – real or perceived – through increasing quality and effectiveness of laws, and predictability and efficiency of their implementation, are pre-requisites for countries to attract, retain and expand FDI. Regulatory simplification, removing barriers to investment entry, and addressing infrastructure constraints rank among the most important confidence-building signals for the investment community.
Global Investment Competitiveness Report 2017-2018 presents novel analytical insights and empirical evidence on foreign direct investment’s (FDI) drivers and contributions to economic transformation. Three key features distinguish this report from other leading FDI studies. Firstly, its insights come from a variety of sources, including a new survey of investor perspectives, extensive analysis of available data and evidence, and a thorough review of international best practices in investment policy design and implementation. Secondly, the report provides targeted, in-depth analysis of FDI differentiated by motivation, sector, and geographic origin and destination. Thirdly, the report offers practical and actionable recommendations to developing country governments.

The report’s groundbreaking survey of more than 750 executives of multinational corporations investing in developing countries finds that—in addition to political stability, security, and macroeconomic conditions—a business-friendly legal and regulatory environment is the key driver of investment decisions. The report also explores the potential of FDI to create new growth opportunities for local firms, assesses the effectiveness of fiscal incentives in attracting FDI, analyzes the characteristics of FDI originating in developing countries—so-called south–south and south–north FDI—and examines the experience of foreign investors in countries afflicted by conflict and fragility.
GIC REPORT BRINGS VALUE TO VARIOUS AUDIENCES

For policy makers, the report offers clear insights into the role of policy and the decision-making processes of investors.

For foreign investors and site location consultants, the report discusses relevant FDI developments and drivers across sectors and geographies.

For academic audiences, the report’s new datasets on investment incentives and FDI motivations offer scope for additional research and analysis.

For development assistance providers, the report highlights approaches for harnessing FDI’s potential development benefits.

For all audiences, the report stresses the central role that private investment can and must play in furthering sustainable and inclusive development.
THANK YOU

We are grateful to the report's many contributors and our donor partners.

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