Economic laws and foreign investment: What can Hainan learn from other countries' experiences?

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ECONOMIC LAWS AND FOREIGN INVESTMENT: WHAT CAN HAINAN LEARN FROM OTHER COUNTRIES' EXPERIENCES? (Part I)

by Professors Ann and Robert B. Seidman(1)

Hainan Province seeks to increase productivity and raise living standards by introducing new economic laws to attract foreign investment. Premier Li Peng has warned that opening the window may let in flies and mosquitoes. Drawing on experience in other developing countries, what kinds of flies and mosquitoes may fly in, and what kinds of economic laws might help to keep them out without shutting the window to desired foreign investments?

Developing country governments the world around compete to attract foreign capital. They all want the same benefits: capital, advanced technologies, managerial expertise, and access to overseas markets to increase export earnings to buy new machines. Transnational corporations are in business, however, not to help poor countries attain development, but to maximize their global profits. Engaged in intense international competition, developing country governments too often not only

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open their windows to attract foreign firms, but take down their screens. As a result, four kinds of unwelcome mosquitoes and flies swarm in.

First, to maximize their profits, foreign firms often take advantage of the host countries' funds and resources while contributing little to development. For example, governments often assume foreign investors bring new capital. Frequently, however, they invest a minimum amount of their own funds, and borrow much more from local banks, or sell shares to local governments, institutions, or individuals so that they operate primarily on locally-generated capital.

Again, governments expect foreign firms to introduce new technologies and skills. But they often bring technology in packages they design and control from their foreign headquarters. They pay local workers low wages to assemble parts or hook wires to terminals. They never teach them to unpack the technology or to repair and ultimately make the parts themselves.

Host governments hope foreign firms will build a pole of growth, stimulating new productive activities, providing jobs and raising incomes throughout an entire region. In many countries, instead, foreign projects operate in enclaves, using imported machinery and equipment, supervised by foreign engineers. They do nothing to stimulate regional development. An oil well in Nigeria provides the extreme case: Once capped, it simply pumps oil into tanks and thence to waiting ships. Around it, village life continues as it always has.

Second, attracting foreign firms may impose excessive costs
on host countries. For example, multinational giants using sophisticated new technologies may oust local enterprises from a profitable field, causing unemployment and wasting local resources. In Zambia, a new foreign factory using imported machines and materials squeezed out many small shoe makers who used locally made leather. A careful evaluation may reveal that the benefits of a foreign investment do not really offset the consequences of reduced use of local resources, increased unemployment and lowered real incomes.

Foreign firms typically demand the right to use foreign currency without government interference. Experience elsewhere suggests they tend to use the host countries’ scarce foreign exchange earnings to import and sell profitable items like air conditioners and electronic toys for the superrich, or to send profits back to their headquarters abroad, rather than to import machinery, equipment and spare parts to improve industrial and agricultural productivity. In Kenya, private trading firms spent a fifth of the nation’s foreign exchange earnings to import Mercedes Benz cars for wealthy individuals, instead of fertilizers and pesticides to raise peasant output.

Foreign firms not infrequently use transfer pricing to evade local currency controls. In Zimbabwe, the local affiliate of a foreign mining firm paid above-world-market prices to purchase machinery from its overseas parent, while selling its minerals exports to it at below-world-prices. In this way, the local mining affiliate manipulated prices to transfer its locally-earned profits in foreign currency to its foreign parent without
paying local taxes.

Research reveals that, everywhere, tax exemptions for foreign investments constitute an unwarranted cost to the host country. First, they only look cost-free, as though the host country merely "gave away" something it had. In reality, it is as if the government collected the tax, and gave the company an equal cash subsidy. Second, since their firms only benefit from tax exemptions after their investments earn income, corporate managers seldom view them as an incentive when making an investment. As one explained, "When we invest, we worry about losing money, not what we'll have to pay if we make it. Income tax credits come like dessert after dinner." In fact, most industrial countries permit national companies to subtract the taxes they pay to foreign governments from the taxes they pay their home government. Thus developing country tax exemptions do not reduce the foreign firms' overall tax burden.

Thirdly, flies and mosquitoes may bring in diseases in the form of corruption, dependency and creation of a new comprador capitalist class. A foreign firm's success in a developing country depends on local allies -- businessmen, intellectuals and other elites -- as well as discretionary decisions by public officials. Foreign firms have cash and other goodies to win friends and bribe officials. Local allies tend to emerge as a comprador ruling class that seldom exercises power in favour of the people.

Lastly, foreign firms typically invest in businesses in developing countries that complement their world-wide commercial
interests: the acquisition of raw materials and labor-intensive manufactures produced by low paid labor, markets for their surplus manufactures, and increased profits. As evidenced by the current debt burden inflicted on most African, Southeast Asian and Latin American governments, foreign firms' investments thus tend to tie the host economy to the international capitalist economy, with its fluctuations and financial crises.

In short, the experiences of developing countries throughout the world suggest the need to devise economic laws to attract only those foreign investments that will help them implement carefully drawn development plans while screening out unwanted flies and mosquitoes.
LEGAL SCREENS AGAINST FLIES AND MOSQUITOES (Part II)

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Experience elsewhere in the developing world suggests several ways of using law to open the window to attract foreign capital, while keeping out unwanted flies and mosquitoes.

First, because geographic, political, economic and social characteristics of one country differ qualitatively from all others, government can never simply copy the laws of another country and expect it to produce the same results. Hainan cannot copy Hong Kong's laws and expect to become another Hong Kong. Hainan can, of course, learn from experience elsewhere, especially about laws that probably will not contribute to development. Hainan must formulate its own law in light of its own obstacles and resources. Those obstacles and resources, of course, inevitably differ from those anywhere else in the world.

Second, to avoid the indiscriminate admission of foreign firms that may waste local resources while contributing little to development, many statutes create a licensing system to admit

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only those firms which meet specified criteria.

The first problem concerns the criteria for granting a licence. Simply to list criteria in vague terms ("improved technology" or "increased employment opportunities", for example), however, leaves too much discretion to the licensing officials. They may not know what technologies or new jobs would contribute to development.

For example, by no means do all new industries create poles of region-wide growth, stimulating other investments that utilize more local resources, provide more jobs, and raise living standards throughout an entire region. To play that role, a foreign private firm must employ local resources (including labor), or produce tools, equipment and materials to increase productivity in local industries. A foreign firm that uses such sophisticated technology that whenever a part needs repair it must be shipped by air to Tokyo, Berlin, or California contributes far less than a plant which can use local machine shops to repair its equipment.

Nor do all high-technology industries help Third World economies. Usually, the host country needs not high technology of every sort, but high technology of very specific sorts. It needs to have the technology sufficiently unpacked so that local workers and engineers learn to service and repair the machines, and how to design new machines using that technology. The criteria in the licensing law should specify the sorts of technology required from time to time, and the degree of unpacking required.

Experience elsewhere suggests that, for foreign firms to
appropriately meet national requirements, the national plan should specify the investments needed to advance the country's overall development -- a fertilizer plant of such-and-such a capacity, the exploitation of a known mineral resource, the introduction of a particular advanced technology. In effect, foreign investors then bid for the opportunity to construct and run those specific enterprises.

Some statutes require the licensing agency to conduct a cost-benefit analysis, balancing the known costs of admitting a foreign investor against the expected benefits. The agency can either forbid a too-costly investment entirely, or admit a marginally advantageous one without granting it costly benefits, like unlimited use of foreign exchange, income tax concessions, or the unlimited export of profits.

How can a statute ensure that officials take the planned criteria into account in granting licenses? A few statutes require them to make their decisions in writing, specifying the factors they considered, and the weight they gave to each. Making that opinion public may provide a way to permit public opinion to influence decision-makers. Procedures enabling anybody affected to appeal the decision make it more difficult for officials to act arbitrarily.

How can the law help make sure that the foreign firm fulfills its promises? Instead of merely licensing a foreign firm to invest in the host country, some statutes require that the license include specific conditions the firm must meet, for example: providing training programs for local workers to repair
and manufacture the new technology; setting a timetable for employing nationals in management positions; using a specified increasing percentage of locally produced materials and parts.

A third set of problems concerns the rewards that the host country pays to induce foreign private investment. Some investment codes include establishing tariff barriers to protect the foreign investor to the detriment of local consumers; easing foreign exchange restrictions; permitting the payment of unlimited profits out of the country; outright subsidies (usually in the form of income tax or import duty relief); building industrial estates for the foreign investors; and a myriad of other concessions.

How can law help to ensure that the incentives the host country provides actually induce new foreign investment, and that the amount of investment it induces bears a prudent relationship to the cost of the inducement to the host government?

Shortly after independence, for example, hoping to induce new foreign investment, Zimbabwe relaxed the prohibition on foreign firms' remittance of profits to their home countries. The following year, foreign investors sent home over $100 million more in foreign exchange than they could have under the previous law, but they brought into the country only about $25 million in new capital. Zimbabwe lost over $75 million in foreign exchange as well as in locally-generated investable surplus.

A variety of legal devices would have enabled Zimbabwe to reinvest these funds. To mention only one, the government could have linked the firm's ability to ship out foreign exchange to
its foreign exchange earnings.

Income tax exemptions constitute a way governments seeking to attract foreign investment frequently lose funds to no purpose. A government that grants tax relief is really just paying the foreign firm a subsidy equal to the tax forgiven. This is particularly undesirable since, under its home-country tax law, the foreign firm frequently can deduct taxes it pays to the host country from the taxes it pays its home government.

Finally, a fourth set of problems arise: How can law help to keep out the really dangerous mosquitoes and flies: corruption, loss of investable surplus, class formation, external dependency?

Many states have enacted laws generally guarding against corruption: creating State Procurators or Ombudsmen, instituting meticulous accounting systems and the monitoring of expenditures by state banking systems, setting up special task forces of one sort or another, and requiring cadres to declare their assets. At especially vulnerable points like foreign exchange controls and import licensing, the more precisely stated the criteria for public officials' actions, the more collegial the procedures (it is more difficult to bribe a group than an individual), the more public the decision-making process, the less likely will corruption creep in.

Various countries have introduced legal devices to hinder emergence of a comprador bourgeoisie class benefitting from ties with foreign investors. Because of their wealth, this new economic ruling class frequently wields disproportionate
influence in government policy-making. Tanzania and other countries have experimented with Leadership Codes, forbidding cadres from owning shares in private firms, from owning rental real estate, employing workers.

Of course, the ultimate control must come from below, that is, by popular participation in decision-making. Achieving that requires policies and laws with a reach much wider than investor control laws.

Formulating techniques to admit desired investments while screening out unwanted effects does not exceed the limits of law. It requires, however, that law-makers direct their attention, not only to the task of opening the window, but to the equally important task of installing the screens.