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PREGLEDNI ZNANSTVENI ČLANKI • REVIEW PAPERS

THE ROLE OF FOREIGN DIRECT INVESTMENT IN RAISING NATIONAL COMPETITIVENESS

Vloga tujih neposrednih naložb pri izboljševanju konkurenčnosti gospodarstva

Abstract

UDK: 339.727.22

In our paper we analyse the 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 analyse the benefits and costs of internalised technology transfer through FDI flows. In general, this mode of technology transfer is a very efficient means 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, internalisation may be the most efficient way of transferring the tacit knowledge involved and in the case of rapid technology changes.

Key words: foreign direct investment policy, competitiveness, Bosnia and Herzegovina

Izvleček

UDC: 339.727.22

V članku analiziramo ustrezno vlogo politike tujih neposrednih naložb (TNN) pri izboljševanju konkurenčnosti gospodarstva. Prvi del razpravlja o vlogi TNN pri prenosu tehnologij, učenju in konkurenčnosti. Tukaj analiziramo stroške in koristi internaliziranega prenosa tehnologije na osnovi tokov TNN. Na splošno je ta oblika prenosa tehnologij zelo učinkovita za prenos paketa kapitala, spretnosti, informacij, omrežij (angl. networks) in blagovnih znamk v razvijajoča se gospodarstva. Za številne tehnologije so internalizirani prenosi edina možna oblika prenosa. Internalizacija utegne biti najbolj učinkovit način prenosa tudi za implicitno ali tiho znanje (angl. tacit knowledge), povezano s prenosom, in v primerih hitrih tehnoloških sprememb.

Ključne besede: politika tujih neposrednih naložb, konkurenčnost, Bosna in Hercegovina

JEL: F21, G24

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 the 1990s.¹ As a result of increased liberalisation and technological advances, FDI flows have increased rapidly during the last few decades. FDI increased as a ratio 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.² A general conclusion of these studies is that the benefits of foreign companies are by no means automatic in terms of economic development, even though they possess a bundle of desirable assets (including 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. In addition, research shows 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, etc.), according to these analyses, is of key importance in shaping the ultimate effect of FDI, suggesting an important role of complementary policy. Different programmes of encouraging linkages between transnational corporations (TNC) and local firms, programmes supporting clusterisation and upgrading FDI are also considered important.

This paper is organised as follows. The first section discusses the role of FDI in technology transfer, learning and competitiveness. Here we analyse benefits and costs of technology transfer through FDI flows and TNC subsidiary characteristics which enable them to contribute more to the national competitiveness of their 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 Ireland and Singapore. Finally, in the fourth section we draw conclusions and give some policy recommendations.

¹ It is important to mention that a more open approach toward FDI has become a necessity, keeping in mind WTO rules and the importance of technology transfer, because they have made it almost impossible for developing countries to build up an industrial capacity behind closed doors.

² These studies focus on different levels of analysis (country, sector or company) and they are different by the number of countries included in the analyses. For a detailed review of the results of this research see Te Velde (2003).

1. THE ROLE OF FDI IN RAISING NATIONAL COMPETITIVENESS

Global FDI flows are dominated by transnational corporations. TNCs 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, TNCs are the main source of international technology transfer. Their role is naturally higher in high-technology activities where production and exports grow much faster than the total world production and exports (Lall, 2003).

In general, technology flows between TNC affiliates (hereinafter: internalized technology flows) are a 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 possible mode of transfer since innovators are unwilling to part with them to unrelated parties. Even where technologies are available at arm's length, internalisation may be the most efficient way of transferring the tacit knowledge involved because of the commitment of the transferer and its capability to support learning. If the technology is changing rapidly, internalisation provides the most direct access to improvements. If the activity is export oriented, internalised 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, internalised 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 standardised and diffused the technology and the more capable the buyer, the more economical will externalised modes be. However, there is a more subtle reason: the existence of learning benefits, deepening and externalities may tilt the choice in favour of externalisation even for relatively 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 internalised 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 centralised 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 to deepen their capabilities and move into the innovation-led competitive-

ness phase, according to Porter's classifications.³ 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 internalised forms to promote local R&D capabilities based on externalised forms, or for intervening in the FDI process to induce MNCs to transfer more advanced technological functions.

The above discussion also implies that TNC subsidiaries with certain characteristics are able to contribute more to raising and sustaining the national competitiveness of the host country. O'Donnell and Blumentritt (1999) point out the following characteristics: (1) the level at 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; and (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 the innovative capability of the host country and its competitiveness. They also may have a synergetic effect. A subsidiary that is both high-tech and 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.

2. FOREIGN DIRECT INVESTMENT POLICY

As already mentioned, FDI flows as well as their share in total investments grow continuously. However, while some countries managed to attract large FDI flows, others were less successful, even if they had liberalised 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 on 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 spillover 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 into the country's development strategy. Since the im-

³ For detailed insight into national competitiveness development phases, see Porter (1990).

plementation of FDI policies require financial resources (through up-front grants, promotion activities, institutional reform, or tax concessions), they should decide if a such an option exists at all, and if using FDI is a more efficient and effective way of realising the objectives set in the development strategy. Finally, they should decide how much the country will rely on FDI in realising its objectives, and also which type of FDI is necessary in 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 information foreign investors are missing, and the other is the divergence in interests between mobile foreign investors and the host economy. Regarding the degree of country intervention in 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 interventions 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 it produce better results.

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

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

2.1. FDI policy in Ireland and Singapore

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

2.1.1. Ireland

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

The visible influence of FDI on the Irish economy has resulted in a large number of papers that stress the importance of different factors in attracting FDI, starting from industrial (Ruane and Gorg, 1999) and macroeconomic policy (Fitz Gerald, 2000), and also some other factors (Ruane and Gorg, 1999) such as location. Some papers also focus attention on policies for upgrading FDI and making 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, employing telephone calls, presentations, provision of research, visits and other meetings. The IDA identified electronics and pharmaceutical companies from the US as offering the best opportunities for FDI led industrialisation.⁴

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.⁵ IDA expenditure per job decreased from over IR£35,000 in the period 1981-1987 to IR£10,000 over the 1993-1999 period. 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 went 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 fifte-

⁴ 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.

⁵ Nowadays, these grants must be consistent with EU rules on state aid, which means that they are still allowed only in low-income regions.

en-year (zero) tax holiday on profits from new export profits beginning in the 1950s, which changed into a 10 % corporate tax to all new firms (compared to around a standard 50 % corporate tax rate by that time) beginning in 1982 to be consistent with EU rules. Under further international pressure, Ireland is now committed to a 12.5 % corporation income tax for all firms starting in 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 until the late 1980s, EU structural funds (6 % of GDP in the 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, use of English as the official language, and more recently the boom in the US electronics sector.

Last but certainly not least, the opening-up of the Irish market, first with the signing of the Anglo-Irish Free Trade Agreement in 1965, and then EU membership in 1973, combined with proximity to the huge EU market, have 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 the 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. Starting in 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 % in 1997, it is rather low according to 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, the National

Linkage Programme has been launched. The aim of this programme is to improve organisational and marketing skills as well as quality and productivity of local firms to bring them 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 % to 21 % in non-food manufacturing, and from 13.2 to 22.8 % 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 dependence on TNCs.

2.1.2. Singapore

There are many stories about Singapore's remarkable development path and the role that FDI has played.⁶ Singapore developed from a struggling low-income colony in the 1960s to a modern and developed high-tech country. GDP growth rates have continued to be 10 % on average over the past four decades. At the same time, the accumulated stock of FDI as a percentage of GDP has risen from 5.3 % in 1965 to 98.4 % in 1998 (Yeung, 2001). In 1997-1998, foreign firms employed 50.5 % of workers in manufacturing, 29.1 % in trade and 25.7 % in finance.

Singapore became independent after a two-year stint with Malaysia failed in 1965. Singapore, though traditionally an important trading port, was now isolated from its hinterland, as Indonesia refused to import goods and Malaysia wanted to cut out the middleman Singapore in its trading activities. Singapore also lacked natural resources and an entrepreneurial business elite. Furthermore, there was the impending withdrawal of the British armed forces, which contributed an estimated 20 % to the economy. All these made an import-substitution strategy virtually impossible. Singapore had no policy option but to industrialise, relying on TNCs to bring 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 the Economic Development Board (EDB) to be responsible for the industrialisation of Singapore. The EDB was founded in 1961 as a one-stop agency with a budget of around US\$ 25 million (over 4 % of GDP). In the beginning of its work the EDB focused 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 begin to build up offices abroad. It had four divisions: investment promotion,

⁶ For detailed insight into FDI policy in Singapore, see Lall (2000).

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 a 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, in contrast to the view of other developing countries 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 the unemployment rate fairly quickly. While 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 % corporation tax for a fixed period of time provided that firms developed new products. As a result, the share of manufacturing output by firms with pioneer status increased from 7 % in 1961 to 51.1 % in 1971, and to 69 % in 1996. Another important tax incentive was the reduction in the corporation tax for capital-intensive industries that were to replace labour-intensive industries.

Over time wages rose, especially in the period 1985-1986, when the county faced its first postwar recession. It was obvious that Singapore could only cope with rising wages if local firms developed capabilities (technical and human resources) and if TNCs continued to upgrade (using R&D incentives, incentives to set-up high skilled headquarters and encouraging joint research institutes through government funding). A special programme was 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 EDB is responsible for the Skill Development Fund. Set up in 1979, it imposed a levy on the payroll

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, petrochemical and engineering industries.⁷ The cluster approach also leads to enhanced linkages and spillovers to the local economy. The 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 tariffs 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 make 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. Furthermore, Singapore never runs government deficits, which is helpful in finding 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. Furthermore, its time zone enabled financial services to fill the gap between the US and Europe during the 24-hour day.

3. BOSNIA AND HERZEGOVINA

In this section first we will give an overview of the economic situation in Bosnia and Herzegovina. Then we will turn to the FDI performance and policy in BiH and its comparison with the experiences of Ireland and Singapore.

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

Bosnia and Herzegovina has a 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

⁷ The EDB began a S\$ 1 billion Cluster Development Program in 1994, and has recently tripled in size.

was 5.5 %, continuing the underlying trend of growth of around 5.5 – 6 %. The Central Bank of Bosnia and Herzegovina (CBBH) that started its operations in August 1997, pegged its currency (the convertible mark) first against the German mark and later the euro through the Currency Board System.⁸ The average inflation rate is the lowest in the Southeast European (SEE) region. BiH has a liberal trade regime with an average tariff rate of 6 percent, the lowest in SEE after Croatia. BiH has also signed free trade agreements with all SEE countries.

Table 1: BiH 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: Agency for Statistics of BiH; Central Bank of BiH

The other side of the economic situation in BiH is as follows: the real GDP in 2005 was only 63 percent relative to 1989, which is much lower compared to the average of transition countries (EBRD, 2005). The unemployment rate is incredibly high. A liberal trade policy compounded with the lack of international competitiveness has resulted in a huge trade deficit. Export to import coverage has been growing slightly in the last few years but is still less than 40 %. The current account deficit in 2004 was about 17 percent relative to GDP (World Bank, p. 24). BiH's revealed comparative advantage in EU markets is concentrated in products with a low level of processing. In addition, BiH exports to the EU are heavily concentrated in natural resource-based and unskilled labour-intensive products. Resource-based products are the dominant category, accounting for 45 % of EU-bound exports in 2002, while unskilled labour-intensive products accounted for 42 %. Unlike experiences in other advanced SEE countries, BiH witnessed limited restructuring in the factor intensities of its exports. The combined share of skilled labour-intensive and capital-intensive products in EU-destined sales remained virtually unchanged at about 13 % over the 1997-2003 period (World Bank, 2005, p. 36-37).

The enterprise sector of BiH is poorly integrated into international production and distribution networks. Firms in

BiH are primarily inward-oriented. For example, over 63 % of the surveyed firms in the second World Bank's Business Environment and Enterprise Performance Survey

(BEEPS2) relied on foreign sources for their supplies of material input. At the same time, export receipts were 10.6 % of sales revenue in 2002, a number lower than the SEE regional average of 12.5 %. Only surveyed firms in Serbia and Montenegro reported weaker export intensity among the eight SEE countries. Surveyed firms in BiH 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 % of the surveyed firms in BiH had reached new foreign customers during the same period. The reaching of new markets by BiH companies between 1998 and 2002 is similar to the international expansion of firms in Albania and Serbia and Montenegro, but considerably lower than that of firms from Romania and Bulgaria (Broadman et. al., 2004).

3.1. FDI policy in Bosnia and Herzegovina

After the 1992-1995 war, foreign nationals have been encouraged to invest in the country and to take part in the privatisation process. Foreign ownership is generally unrestricted, except in a few sectors where it is limited to 49 % of 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. A guarantee is given to investors, in the event of a change in legislation, to choose to be subject to the law that is more 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 the 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 opportunities to potential investors, and assists them in establishing joint ventures or greenfield operations.

Bosnia and Herzegovina enhances its attractiveness for FDI by 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 % in the Federation of Bosnia. The Federation law on

⁸ Convertible mark is pegged to the euro at a fixed exchange rate of KM1 = Euro 0.51129.

Table 2: Inward FDI in SEE region

FDI flows	In millions of dollars				As % of gross capital formation			
	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
Bosnia and Herz.	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)

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 % of total capital. This incentive includes companies with 100 % foreign capital investment. The rate of corporate income tax is invariably 10 % in the Republic of Serbia. Bosnia and Herzegovina introduced VAT on 1st of January 2006 at a flat rate of 17 % on all goods and services and it is collected at the state level.

Access to any of the nine Free Trade Zones (FTZs), where most activities may be performed, is possible to both local and foreign investors. Additional benefits are granted to firms operating within an FTZ boundary. Goods manufactured or transformed in the zone may also be sold on 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.

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

3.2. Comparison of BiH with Ireland and Singapore

Here we will make some interesting comparisons between FDI policy in BiH and the experiences of Ireland and Singapore.

- 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. The Foreign Investment Promotion Agency (FIPA) in BiH has no political power. It has around twenty employees. Because of relatively low salaries, FIPA is facing the problem of frequent

turnover of its staff. In the last few years its budget has remained unchanged at around 1.5 million 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 if it is export oriented or not. BiH has applied a 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. Neither FIPA nor any other political entity in BiH has even analysed the issue of potential gaps between TNCs and the local economy. It is left to market forces.
- Both countries launched programmes of upgrading established foreign investors to solve the problem of rising factor prices. In BiH there is no political entity which is authorised to follow activities or launch programs directed toward existing foreign investors.
- What is maybe the most important is that in the case of both countries, FDI policy was clearly integrated in 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.⁹

Conclusions and policy recommendations

Based upon renewed confidence in the positive effects associated with FDI, many developing countries are inc-

⁹ Both of these countries had favourable external factors, but according to the studies reviewed here they were not decisive in attracting FDI.

reasingly 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.

The importance of different policies depends on the characteristics of the specific country, 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 policy is 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 are used to affect the locational decision of foreign investors, the upgrading of 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.

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

- First of all, BiH has to integrate 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;
- It needs to start target specific firms that fit into its development strategy and 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.

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