

2010-2011

EXPLANATION OF SCORING SYSTEM

**Assessing Developed Country Efforts to Support Developing Country
Growth via Foreign Direct Investment**

What kinds of measures can developed countries take to facilitate the flow of foreign direct investment to developing countries, and ensure that the projects involved support (and do not detract from) host country growth and welfare?

This assessment is derived from *Harnessing Foreign Direct Investment for Development*, Theodore H. Moran, Center for Global Development, 2006, and revised analysis through 2010.

Developed Country Measures to Help Developing Countries Benefit from FDI

Providing an answer to the question of how developing countries can facilitate the flow of foreign direct investment to developing countries, and ensure that the projects involved support (and do not detract from) host country growth and welfare, involves a certain amount of conjecture.

Surveys of what international investors say they want in order to engage in FDI compile long wish-lists of subsidies and special favors that might or might not be decisive in influencing any given investment decision, and might or might not be desirable to help host country development.

Measurements of “additionality” – the amount of “extra” FDI generated by a given developed country policy tool, the reduction in FDI that would take place “but for” a given developed country action – have been notoriously difficult to construct.

Developed country policy measures that are strongly advocated by the multinational investment community sometimes – as reported later – show no statistical correlation whatsoever with the actual outcomes of international investment flows.

Despite the uncertainties about which developed country instruments affect outward flows of international investment to developing countries by how much, the following sections point to three areas in which developed countries policies are clearly important. These are 1) provision of national or multilateral political risk insurance; 2) avoidance of double taxation of profits earned abroad; and 3) regulation to combat bribery and to prevent diversion of public revenues to private pockets.

At the same time, some developed country policy actions clearly hinder outward FDI flows. For example, national, state, and municipal authorities in the developed world often offer substantial packages of locational incentives to attract multinational investors to their own economies, or to keep them from leaving. The potency of these locational incentives in dampening and discouraging outflows of FDI to developing countries has been growing over time.

Finally, there is a significant interaction between trade liberalization and the facilitation of FDI that extends beyond the scope of this assessment. Multilateral trade liberalization and bilateral or regional trade agreements have as a byproduct the stimulation of foreign direct investment flows among the participants. Conversely, developed country protection against imports and subsidies for local production (such as agricultural support programs) undermine the ability of international investors to use poor host economies as platforms for export. Antidumping regulations that are filed for reasons other than international price discrimination have the protectionist effect of deterring foreign investment – developing countries with a comparative advantage in industries that range from processed seafood and fruit juices, to manufactured products, to chemicals and

petrochemicals, find exporters, including foreign-owned exporters, penalized and discouraged from expanding investment.

The Rationale for Public Support: Market Failures and Externalities

What does it mean for developed countries to “facilitate”, “support”, or “promote” flows of foreign direct investment to the developing world?

On the one hand, it could mean that developed countries simply remove barriers in the way of outward FDI flows to developing countries, but do not take special measures to encourage such flows.

On the other hand, it could mean that developed countries design policies that explicitly discriminate in favor of outward investment to developing countries – tilting the playing field, so to speak, to reward outward FDI to the developing world more generously than other kinds of investment.

In between, it could mean that developed countries devise mechanisms to correct for market failures that hinder flows of foreign direct investment to developing countries, when such flows generate externalities for the capital-importing and capital-exporting countries involved.

This assessment includes the first and the last approaches to public support – removal of barriers to investment flows, along with light-handed measures to overcome market failures and allow enjoyment of externalities.

Appropriately structured FDI projects in manufacturing and assembly can make a strongly positive contribution to host country development, adding to the capital base, improving efficiency in use of local resources, and altering the production frontier of the host economy.

Vital to the discussion here, however, FDI in manufacturing and assembly can also generate externalities – economic and social benefits for the host country beyond what can be appropriated by the investors themselves. Foreign investment projects not only utilize host country resources more productively and make a larger contribution to host country growth than domestic investment, but they also train workers and managers who leave the foreign firm and move throughout the host economy, and transfer technology, management techniques, and quality control procedures to other firms in the host country (in particular, in a vertical direction to suppliers, but also sometimes in a horizontal direction to rivals).

FDI in natural resources and infrastructure can also make a substantial contribution to host country development. Petroleum and mining industries generate resource rents, a large portion of which can be taxed away by public authorities – if corruption and diversion are prevented – for broad public use. Well-functioning infrastructure allows

local businesses to operate more competitively, expanding employment and generating more rapid economic growth.

Outward investment from developed countries – conventional wisdom notwithstanding – actually enhances the export performance of home-based firms that make the investment, improves the proportion of high wage-high benefit jobs in the home economy, and reinforces the stability of earnings in communities where globally-engaged firms are located.

Vital to the discussion here, once again, is the discovery of externalities – that the social value of the global trade-and-investment-related activities to the home economy is larger than the benefits that can be captured by the firms that undertake the outward investment.

Thus, not only can FDI from developed to developing countries enhance welfare, growth, and the creation of good jobs in both capital-exporting and the capital-importing states, but FDI can also generate externalities for both sides in the process.

These beneficial results and positive externalities do not, however, emerge from every FDI project. Some FDI projects detract from welfare. Some FDI revenues are diverted to corrupt officials. Some FDI projects abuse treatment of workers. Some FDI projects harm the environment.

Thus, within the mechanisms to facilitate FDI flows to developing countries, there is a rationale for developed countries to separate out those investment projects that do provide positive benefits to both sides, from those that do not, and to support the former but not the latter – or, to take measures to turn the latter into the former.

Provision of Publicly-Backed Political Risk Insurance

The inability to make credible commitments about the treatment of foreign investors that endure from one minister to the next, or from one government administration to the next, constitutes a market failure for many developing countries. The phenomenon of breach of contract occurs most frequently in natural resource and infrastructure projects, but is present in other sectors as well.

“Pioneer projects” and “first movers” are particularly prone to the dynamics of the “obsolescing bargain”, but later investors are subject to this same process of forced contract-renegotiation as well, especially if they involve large fixed investments and long payback periods: precisely the kinds of projects, paradoxically (and perversely), that are likely to generate substantial externalities for the host economy.

Private political risk insurers – such as Lloyds of London, Zurich, or the political risk insurance arms of the former AIG -- can play only a limited role in dealing with breach of contract. They offer compensation if host countries take political actions that damage the project covered. The existence of private insurance policies is often kept secret, so that host authorities do not single out well-covered projects for harsh treatment (knowing that the investor will not actually suffer large losses).

Quasi-official political risk insurance, such as that provided by multilateral lending agencies like the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, or by regional development banks such as the Inter-American Development Bank, or by national agencies such as the Overseas Private Investment Corporation (OPIC) of the United States, also offer compensation.

But their “extra” facilitative support for investors comes in the form of *deterrence* against hostile actions on the part of the host authorities.

As a consequence, official political risk insurance – from a national or multilateral provider – can help provide credibility to host country promises about treatment of foreign investment projects, especially politically sensitive projects. The presence of multilateral or national political risk insurers in a project aids in overcoming the market failure associated with imperfect contracts by helping host authorities to “bind the hands” of themselves and their successors, to limit opportunistic behavior.

Official political risk insurers – especially MIGA, or the counterpart in a regional multilateral development bank like the Inter-American Development Bank, Asian Development Bank, or the European Bank for Reconstruction and Development – can also help mediate potential disputes behind the scenes before they become actual claims.

The involvement of national or multilateral insurers thus provides comfort to foreign investors as they contemplate a risky project. But the rationale for official “support” does not extend to a subsidized rate for the insurance. It would be inappropriate for a multilateral guarantee agency such as MIGA, or a national political risk insurer such as OPIC, to use the ability to borrow with the full faith and credit of the World Bank or the US Treasury to under-price insurance from private suppliers or drive them out of business.

Investigating and comparing rates of official and private-sector political risk insurers is not easy. Private insurers do not make the rates they actually charge clients public. Private insurers sometimes provide global policies across bundles of countries and sectors, and give a portfolio discount. Private insurers often offer multiple kinds of insurance, adding property or casualty coverage to political risk insurance, and perhaps other business services as well.

A study using confidential internal data, commissioned by the Overseas Private Investment Corporation from a prominent Lloyds broker, compared OPIC’s insurance

rates with comparable private sector coverage, and found that in many cases OPIC's premiums were actually higher than private premiums, notwithstanding OPIC's ability to raise capital with the backing of the US government.¹ In general, OPIC rates appeared to be lower than those of the private sector in high-risk markets and higher in low-risk markets (in part due to less vigorous competition among private insurers in the former and more vigorous competition in the latter).

One method to maintain the deterrence benefit from official coverage while avoiding inappropriate pricing on the part of official insurers might be found in structures like MIGA's Cooperative Underwriting Program (CUP). The CUP arrangement essentially allows MIGA to take the lead in syndication, with the participants receiving a common insurance rate that they all agree upon. MIGA acts as the insurer of record, and takes the lead in pursuing recovery in the event of a loss, providing the "halo" of deterrence for all participants.

Facilitating outward FDI to developing countries therefore requires policies that allow firms in the home country to participate in the political risk insurance of multilateral lending institutions. Japanese investors, for example, can take advantage of the services of MIGA since Japan is a member of MIGA. In ranking the performance of developed countries in facilitating FDI flows to the developing world, Japan would receive credit in this category, but a country that was not a member would not.

Scoring Formula: A country will receive 5 points for membership in MIGA, 3 points for membership in the IFC (because ostensible IFC protections via B-loan syndications are useful to a much narrower array of investors than MIGA coverage), and 2 points for membership in appropriate regional development banks (e.g. one would expect Belgium to be a member of the EBRD, but not necessarily to be a member of the Asian Development Bank).

It is important that official political risk insurers not provide coverage indiscriminately, without evaluating the positive or negative consequences of the investment. The evidence examined there indicated that FDI in manufacturing and assembly subtracted from host country output when it involved projects oriented toward small, protected local markets.

Here many developed countries would receive a poor grade. A survey of 19 developed countries with political risk guarantee agencies, in 2009-2010, showed that 15 (including those in the United States, United Kingdom, Canada, France, Germany, Italy, and Japan) do not screen projects to disqualify those that depend upon protection to survive.²

¹ Berry, Palmer & Lyle. 1998. *A Study of the Political Risk Insurance Premium Structure of the Overseas Private Investment Corporation*. London: Berry, Palmer & Lyle.

² Foreign Policy/Center for Global Development Commitment to Development Index November 2010.

More damaging, the community of developed countries has failed to exert pressure upon multilateral guarantee agencies where they have a strong voice – such as the International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, or the Inter-American Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development – to initiate such a screening process within these institutions.

Multilateral or national political risk insurers behave in a counterproductive manner when they spread the umbrella of their support over projects that harm host country growth. To avoid this, they need a vetting process that identifies and refuses support for FDI undertaken behind trade barriers to substitute for imports. In this context, the use of project profitability as the sole criterion for providing coverage is not at all sufficient, since many projects that rely on trade protection turn out to be veritable cash-cows for the parent investor, even though they distort the local economy and damage the prospects for growth.

As part of the determination of eligibility, official political risk insurers should also ensure that projects meet the World Bank's baseline environmental guidelines (including requirements for pre-investment environmental impact assessments for sensitive projects), arrange for follow-up monitoring to be carried out by qualified independent auditors, and provide for the results to be made public on a timely basis with wide local disclosure. Projects that are rejected on environmental grounds should be so-identified.

Of the 21 principal capital-exporting developed countries, only Ireland, New Zealand, and Switzerland do not have a national political risk insurance agency that screens the applications of outward investors for compliance with the World Bank's baseline environmental guidelines.³

Turning to evaluation of the effects of outward investment projects on the home economy, national political risk insurers have a legitimate right to assess the impact of providing coverage for a proposed applicant on domestic workers and communities. To accomplish this, the test for support should be what would happen in the home economy if a given proposed investment did *not* take place.

The rigorous answer is that in the great majority of cases the home economy would be less vibrant, the competitive base of investor would be weaker, and the number of high-productivity jobs paying favorable wages and benefits would be smaller. Keeping firms at home – or denying them help to overcome market failures in moving abroad – would leave the home economy *worse off* than is the case when they are able to take advantage of opportunities around the world.

³ Foreign Policy/Center for Global Development Commitment to Development Index, November, 2010.

The appropriate test for home country support is not, would this outward investment project result in any job loss? The appropriate test is not even, would this outward investment project help or hurt the current net employment rate?

But some national political risk insurers are forbidden to consider support for outward investment in projects if a plant is to be closed or some workers are to be laid off. Some national political risk insurers are not permitted to provide support at all for outward investment on the part of firms in “sensitive sectors” of the home economy, such as textiles, footwear, electronics, auto parts, and steel.

Such prohibitions are inappropriately restrictive – since they do not comply with the “better-or-worse-off-if-the-investment-were-not-made?” test -- and do not serve the interests of the home economy or the interests of the developing world. Developed countries with such prohibitions should receive poor marks as facilitators of FDI flows to the developing world. Two of 19 developed countries with national political risk insurance agencies apply badly-conceived home country economic tests to projects. These are Austria and the United States.⁴

Which firms in the home country should be eligible for national political risk insurance?

Here there has been a pronounced transformation of analytic perspective over the past decade. Originally, when national political risk insurance agencies were launched, the prevailing approach was that home country support should be limited to home country companies. But debate about “Who is US?” has transformed the notion of which firms should be eligible, shifting away from narrow nationality-of-ownership criteria to broader criteria related to the extent to which firm operations touch the lives of workers, managers, suppliers, and communities on the ground in the home economy, independent of who owns the firm.

According to the new criteria, any firm that has a significant presence in the home market deserves support in using that home market as a hub for investment in the developing world. On this basis, companies of any national origin with a significant presence in Canada, for example, are eligible to purchase political risk coverage from Export Development Canada.

Restricting national political risk coverage to firms that are wholly-owned (or even majority-owned) by home country nationals does not maximize the benefit from outward investment for the home country, nor maximize the benefit from inward investment for the developing world.

In the US, in contrast to Canada, only US companies can purchase political risk coverage from the government’s political risk insurer. The interests of both home and host countries would be better served if the Swiss government agency provided political risk coverage for outward investment from any firm with a substantial presence in the Swiss home market. Three of 19 developed countries with national political risk insurances

⁴ Foreign Policy/Center for Global Development Commitment to Development Index, November, 2010.

agencies limit coverage to nationally-owned firms, namely Greece, and the United States.⁵

Finally, the screening mechanisms that multilateral and national political risk insurers set up can be important monitors for evidence of bribery and corruption. To be sure, political risk insurers – as a rule -- are not structured or empowered to engage in formal investigation of wrongdoing, but they can be careful to refuse to insure projects of questionable character, and watchful to turn evidence of misbehavior over to the appropriate justice authorities, as discussed infra.

Scoring Formula: A country will receive 15 points for having a national political risk insurance and guarantee agency. From this, 4 points will be subtracted if the national agency does not screen and monitor environmental, labor, and human rights standards; 2 points will be subtracted if the agency has restrictive sectoral constraints; 2 points will be subtracted if the agency has inappropriately restrictive home country impact constraints; 2 points will be subtracted if coverage of inefficient and counterproductive import substitution projects is allowed; 2 points will be subtracted if eligibility is limited to nationally-owned firms.

Mechanisms to Avoid Double Taxation

A foreign investor may be exposed to double taxation if the investor is required to pay an income tax or royalty to the host government, and then again to the home government when the income from the developing country project is remitted or consolidated with its home country earnings.

Double taxation constitutes a barrier to the foreign investment process. A tax sparing agreement, or the use of a foreign tax credit, can eliminate this obstacle.

In addition, a tax sparing agreement helps the developing country to attract foreign direct investment by offering a low tax rate or a tax holiday. If a host country were to grant a 10% tax rate to foreign investors, or award a “pioneer status” tax holiday to foreign investors, the home country would simply collect the difference between the host country rate and the home country rate when the foreign earnings were repatriated or consolidated if there were no tax sparing arrangement.

Some tax regimes that avoid double taxation may be more efficient than others, but it is difficult to evaluate how much of a difference alternative approaches make. Some researchers argue that tax sparing regimes make a large difference in facilitating foreign

⁵ Foreign Policy/Center for Global Development Commitment to Development Index, November, 2010.

direct investment in comparison to foreign tax credit regimes; others dispute this and argue that the two are not very different in practice.

From a development perspective, it is important to assess whether developed countries have home country tax regimes that do not allow foreign investors to enjoy the benefits of developing country tax incentives, or even do not allow foreign investors a foreign tax credit at all (only allowing them to count foreign taxes as a business expense).

Multinational business groups have long contended that bilateral investment treaties (BITs) are essential not only to avoid double taxation, but to stimulate FDI flows more generally.⁶ But there is remarkably little support for this latter assertion. In 1998, UNCTAD tested whether the number of BITs signed by any given host was correlated with the amount of FDI it received. It found no evidence that BITs increased flows of foreign direct investment.⁷

In 2003, Mary Hallward-Driemeier tried a retest that examined the bilateral flows of OECD members to 31 developing countries over twenty years.⁸ The analysis showed that countries that had concluded a BIT were no more likely to receive additional foreign direct investment than were countries without such a pact.

Driemeier then investigated whether a BIT might act as a signaling device that would draw multinational investors' attention to a particular country, generating an increase in flows following completion of the BIT agreement. But there was no significant increase in foreign direct investment in the three years after a BIT was signed in comparison to FDI during the three years preceding the negotiation. Finally, investigating whether the presence of a BIT affected the relative amount of FDI from a given developed country to a given developing country, no statistically significant correlation emerged.

More recent research continues to show an ambiguous relationship between BITs and FDI flows.⁹

Scoring Formula: A country will receive 20 points if it uses tax sparing provisions and 18 points if it uses a foreign tax credit. It will be penalized if it relies on individual BITs to avoid double taxation, depending upon the

⁶ E.g. "Businesses Call for Ambitious FTAA in Light of Failed WTO Talks", *Inside US Trade*, September 10, 2003, p. 1.

⁷ UNCTAD (United Nations Commission on Trade and Development), *World Investment Report* (New York: United Nations, 1998).

⁸ *Global Economic Prospect and the Developing Countries 2003: Investing to Unlock Global Opportunities* (Washington, DC: The World Bank, 2003), p. 129.

⁹ For a summary, see Karl P. Sauvant and Lisa E. Sachs., eds.. 2009. *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows*. Oxford: Oxford University Press.

extent of BIT coverage. The country will be penalized 6 points if the home country tax system denies foreign investors the benefits of tax exemptions, incentives, or low tax rates in developing countries. It will be penalized 10 points if it allows foreign taxes as an expense, not a credit.

Developed Country Efforts to Prevent Bribery and Corrupt Practices

The OECD Anti-Bribery Convention of 1997 has become the central international mechanism to ensure developed country prosecution of corrupt payments from multinational investors to public officials in developing countries. As of 2007, all 30 OECD members and a number of non-members have enacted anti-bribery laws based on the OECD Convention, making a bribe by one of their multinationals to an official in a developing country a punishable offense.

Signatories to the OECD Anti-Bribery Convention then go through a two phase peer-review examination process. Phase 1 involves an assessment of the conformity of the country's anti-bribery laws with the OECD convention. Phase 2 consists of one week of intensive meetings in the examined country between experts from other OECD states and key actors from government, business, trade unions and civil society to assess how effectively that country's anti-foreign bribery laws function in practice. In 2009, the OECD initiated Phase III consultations that focus on enforcement. As Phase III progresses, the completion of consultations and response to queries will be taken into account in this score.

Recent research – some sponsored by CGD—offers evidence from Asia, Africa and Latin American that U.S., European, and Japanese multinationals have found a gaping loophole – in both the OECD convention and the FCPA -- that allows them to win contracts and obtain favorable treatment without fear of prosecution.¹⁰ Detailed investigation of international investment contracts shows U.S., European, and Japanese companies using sophisticated current-payoff-and-deferred-gift structures to relatives and friends of host country officials that do not technically put them at risk of OECD-consistent home country anti-bribery laws, or the U.S. Foreign Corrupt Practices Act.¹¹

¹⁰ *Money Laundering and Foreign Corruption: Enforcement and Effectiveness of the Patriot Act: Case Study Involving Riggs Bank.* Report prepared by the Minority Staff of the Permanent Subcommittee on Investigations, US Senate, July 15, 2004. *Approved Judgement* of the Honourable Mr. Justice Cooke between Kensington International and the Republic of Congo in the High Court of Justice, Queens Bench Division, Commercial Court, Royal Court of Justice, Strand, London. November 28, 2005.

¹¹ Louis T. Wells and Rafiq Ahmed. 2007. *Making Foreign Investment Safe: Property Rights and National Sovereignty.* New York: Oxford University Press. Theodore H. Moran. 2006. *Harnessing Foreign Direct Investment for Development: Policies for Developed and Developing Countries.* Washington, DC: Center for Global Development.

The basic structure has been for the multinational to approach a prominent family member or close friend (hereafter, “connected party”) of the host country leadership about forming a partnership to develop the target investment project (or respond favorably when approached by a connected party about forming a partnership), loan that connected party the funds needed to take an equity stake in the project, and pay a dividend that is more than what was needed to service the original loan. This arrangement functions as a deferred gift – the loan to fund the equity stake of the connected party was paid off via the dividend over time. The excess return above what was needed to service the loan was a current payoff.

Unlike a genuine equity investor, the family-member-or-close-friend partner had no capital at risk, nor any responsibility to repay the loan. The equity stake came to the connected party for free – the only “service” that was required was to ensure the foreign company was chosen to receive the infrastructure concession. In some cases, the connected party partner began to receive “dividends” as soon as the concession was awarded, before the project was even in operation. An added “benefit” to the international firm from these arrangements is that since the return to cover the loan payments and the current payoff depended upon the project remaining profitable, the connected party had an on-going interest in protecting the project from competition.

Particularly startling has been the discovery that some of these sophisticated payment mechanisms – as deployed by U.S. investors to obtain infrastructure concessions in Indonesia – had been vetted by well-respected U.S. law and accounting firms as part of the investors’ due diligence prior to committing funds, and reported to the U.S. Securities and Exchange Commission, without objection.

Why were these payoffs to family members, business associates, and cronies of developing country Ministers and Presidents not illegal under home country legislation consistent with the OECD Convention to Combat Bribery, in particular, the U.S. Foreign Corrupt Practices Act?

The reason is that scope of the 1999 OECD Convention Against Bribery is extremely narrow – requiring member states to pass domestic legislation that does no more than criminalize a straight payment to a public official, or a payment to third parties with the official’s knowledge or direction, by an international company to secure a contract. With regard to the FCPA, the Department of Justice is precise about the limited extent of the statute: “Recipient -- The prohibition extends only to corrupt payments to a *foreign official, a foreign political party or party official, or any candidate* for foreign political office.” The word – “only” – seems to instruct parties reading the DOJ *Guide to the FCPA* that arrangements that do not involve direct payments to officials are not illegal.

These findings have been reported to the OECD Working Group on Corrupt Payments, as well as widely publicized. Unless developed countries can show that they have taken steps to try to revise the OECD Convention, or to issue interpretative statements to close the loophole, there will be a penalty of two points.

Turning next to the expansion of publish-what-you-pay and publish-what-you-spend practices, developed country authorities and multilateral agencies can only achieve limited progress on their own. Vital to this endeavor is the endorsement and wholehearted participation of developing country authorities – requiring all potential investors to take part, including public and private companies from home countries that do not require such transparency. Developed countries have a role in encouraging developing countries with whom they have special relationships to take part. They can also contribute to the World Bank’s Trust Fund, and provide bilateral support to build independent monitoring capacity within individual developing countries and sponsor widespread timely disclosure. Ultimately developed countries may decide that it is counterproductive to continue to provide assistance – including multilateral financial assistance – to developing countries that do not take part in the Extractive Industries Transparency Initiative, the Kimberly Process (for diamonds), and other such programs.

Scoring Formula: A country will receive 10 points if it has completed Phase II examinations. Modification for Phase III examinations will be added in future years. A country will receive up to 16 points for participation in the Extractive Industries Transparency Initiative (EITI), the Kimberley Process Certification Scheme (KPCS) for diamonds, and the International Tropical Timber organization – depending upon the degree of participation in the initiative(s), level of effort in persuading developing countries to take part, provision of assistance to LDC governments and/or NGOs to conduct audits and other monitoring procedures, and contribution to the World Bank Trust Fund to combat bribery. A country will receive 4 points if it scores in the first cluster (lowest reputation for paying bribes) of the 2008 Transparency International Bribe Payers Index, 3 points in the second cluster, 2 points in the third cluster, and 0 points in the fourth cluster. Countries that are not included in the Transparency International Bribe Payers Index will receive the same as the third cluster, 2 points.

In 2010-11, as before, there will be a special bonus of up to 6 points for leadership on EITI issues (e.g. Norway has been a leader of the EITI effort, has made Statoil a model, has helped influence several LDCs to join, and is a contributor to the World Bank Special Trust Fund).

There will be a special 4 point bonus for evidence of vigorous action to punish home country bribe payers, and a 4 point penalty for evidence of negligence in identifying bribery and corrupt practices on the part of home country firms abroad. Unless developed countries can show that they have taken steps to try to revise the OECD Convention, or to issue interpretative statements to close the loophole, there will be a penalty of two points.¹²

¹²For details, see Moran, *Harnessing Foreign Direct Investment for Development*, *op. cit.*

*Other Measures to Facilitate Foreign Direct Investment Flows
to Developing Countries*

In some developed countries, the Foreign Service or Commercial Service is trained to help home country firms to find investment opportunities -- as well as export opportunities -- in the developing world. Corporations often follow a regular progression from supplying exports to an external market, to setting up an in-country marketing network, to assembling components within the host country. Developed countries that offer a seamless web of support in identifying export, marketing, and investment opportunities have the greatest likelihood of solidifying the competitive position of their home firms in the host market. This is particularly valuable for smaller or less experienced firms. Other developed countries do not train or use their Foreign Service or Commercial Service to engage in this kind of support for outward investors – or explicitly forbid them to do so -- captured by the mistaken notion that keeping investors at home will preserve home country jobs.

Another measure developed countries can take to facilitate FDI flows to developing countries is to provide support for host investment promotion agencies. A well-staffed and up-to-date investment promotion agency – complete with real-time links to relevant ministries and satisfied investors --can play a key role in attracting new investment projects, even in poorer developing countries.

Financial assistance and technical support from developed countries have often made a crucial difference. The Lesotho National Development Corporation (LNDC), charged with attracting and promoting foreign direct investment, for example, was established with support from – and has been owned 10 percent by -- the German Finance Company for Investments in Developing Countries. In the first three years of its existence it attracted 55 export-oriented investors, employing 32,000 workers, with exports of garments, electronics, and processed foods worth \$216 million.

In prior years, the Investment Index has awarded points to states that have provided assistance to developing states for the establishment and maintenance of investment promotion agencies, but – beginning in 2008 – this was not separated out so as to avoid “double counting” with the official assistance component of the Index.

Scoring Formula: A country will receive 5 points for training and using its Foreign Service or Commercial Service to help identify investment opportunities (as well as other commercial opportunities) for home country firms in developing countries. Up to 5 points will be subtracted for evidence that a country engaged in advocacy to prevent implementation of internationally recognized labor, environmental, or human rights standards within the previous four years.

There is well-deserved controversy about the desirability, sequencing, and pace of liberalizing the capital account in developing countries. On the one hand, there is a legitimate concern that this might exacerbate exposure of developing countries with weak banking systems and regulatory institutions to financial instability and speculative attacks. On the other hand, the opening of stock markets to foreign investment has been associated with lower costs of capital, investment growth, and increases in the rate expansion of output per worker.

This index does not attempt to make a judgment about when developing countries might decide it is beneficial to take the risks associated with capital account liberalization. For countries that have taken the decision to open their economies to portfolio investment, however, the index will track developed country measures to help or hinder flows of portfolio investment to the developing world.

Some countries provide official support for design of effective developing country securities institutions and regulations. This will receive a positive score.

Many developed countries increasingly supplant or supplement their state-run pension systems with pension funds that are allowed to invest in private equities. The managers of these funds are subject to various kinds of “prudent person” investment regulations governing diversification and exposure to risk. This will not receive any scoring penalty as long as the managers are allowed to diversify their risk by investing in emerging markets. If the regulations contain blanket prohibitions on state-run pension funds or private pension fund investment in foreign securities (like some US states) or impose particularly heavy tax burdens on foreign holdings, this will receive a negative score.

Some countries have a policy of promoting portfolio investment in developing countries. For example, an official agency may provide loans or guarantees to home country investors/fund managers to invest in LDC equity markets (like the programs of OPIC and the IFC).

In the past, the Investment Index has awarded points for providing official assistance to help developing countries to design securities institutions and regulations, but this was discontinued in 2008 so as to avoid “double counting” with the index of official assistance.

Scoring Formula: There is considerable dispute about the advisability and timing for developing countries to liberalize their capital account, in view of the possibility of speculative instability and financial crisis. Thus, there may be considerable variation in developing country determinations about their opening security markets to foreigners. The scoring system will focus on whether developed countries place impediments in the way of pension fund equity investments when developing countries desire them, with 15 points for no impediments. Countries will receive an additional 5 points for using their export-import and political risk agencies to support, fund, or guarantee outflows of portfolio investment.