Competing for Business

Sustainable Development Impacts of Investment Incentives in Southeast Asia

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International Institute for Sustainable Development (IISD)
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Executive Summary

Recent decades have seen a proliferation of investment incentives around the world as governments seek to attract increasingly mobile foreign direct investment (FDI) in the hope of spurring economic growth, raising employment and bringing technology and know-how to the country. Southeast Asia is no exception to this trend. The region has seen substantial growth in FDI inflows over the last three decades, reaching US$60 billion in 2007, a 15-fold increase compared to FDI substantial inflows in 1987. All Southeast Asian countries have offered incentives to foreign investors over the years, although the timing and extent of investment promotion has differed among the countries.

Investment incentives in Southeast Asia

Singapore, which continues to attract the lion’s share of investments in the region, was the first Southeast Asian country to aggressively promote FDI in the early 1960s, and in 2006 was ranked as offering the most attractive investment incentives in the world. Following Singapore’s lead, other countries in the region soon followed suit. Malaysia and Thailand began providing generous incentives since the late 1960s and early 1970s, with a renewed push in the mid-1980s to capitalize on the relocation of manufacturing companies from Japan and Asia’s newly industrialized economies. The Philippines first started offering limited incentives in the late 1960s, but serious efforts to attract FDI only began in the 1990s. While Indonesia also introduced investment incentives in the late 1960s, tax incentives for foreign investors were abolished in 1984, some of which were re-introduced in the 1990s. Cambodia, the Laos and Vietnam only started opening up to FDI in the 1980s.

The most widely available incentives in Southeast Asian countries are tax incentives—usually granted for a defined period and with certain eligibility criteria—and reduced duties on capital goods and raw materials used in export-oriented production. Moreover, all Southeast Asian countries have set up designated zones where investors can benefit from special tax benefits, infrastructure and streamlined administrative procedures. In addition to attracting FDI overall, many incentives provided by Southeast Asian countries aim to meet other development objectives, such as promoting investments in underdeveloped regions or attracting investments to certain types of industries and sectors. Yet other incentives are meant to promote value addition and the transfer of technology and know-how. In addition to positive incentives, several countries have also imposed certain restrictions, for instance to ensure employment opportunities for local workers and limit access to sensitive sectors.

Impacts of investment incentives on sustainable development

While the use of investment incentives is widespread in Southeast Asia, their actual impacts on foreign investors’ decisions about where to invest, in what and how much remain poorly understood. More importantly, the quantity of investments is not a sufficient indicator to judge the success of incentives. Instead, it is necessary to assess the impacts of incentive-induced FDI on the countries’ policy objectives related to economic growth, social development and environmental sustainability. Understanding such impacts can be challenging due to difficulties in assessing the costs and benefits of investment incentives and isolating the role of incentives from other factors.

Regarding the impacts of incentives on economic growth in Southeast Asia, a review of the existing literature points to mixed results. Incentives provided by Singapore, Malaysia and Thailand are thought to have played a major role in attracting FDI, which in turn has been a key driver of economic development and export growth, notably in the export-oriented electronics sector. While export growth
would likely have happened even without the presence of foreign investors, foreign enterprises greatly accelerated that process. Similarly, Cambodia’s rapid expansion of the Chinese-dominated garment industry since 1995 has sustained economic growth over the past decade. Some export processing zones, for instance in Malaysia, the Philippines and Singapore, have also succeeded in attracting significant amounts of investment, in particular in labour-intensive, export-oriented industries.

However, experiences in Southeast Asia have also shown that incentives are certainly not a sufficient condition for attracting FDI and a number of other factors—such as political stability, social and physical infrastructure, cost variable, the macroeconomic environment and institutional development—will be equally if not more important in shaping FDI decisions. For instance, political and economic instability in the Philippines and Indonesia in the 1980s and late 1990s respectively has deterred foreign investors despite the availability of investment incentives. A number of studies have shown redundancy rates (i.e., would investments have been made anyway in the absence of incentives?) of somewhere between 70 and 80 per cent in Vietnam, the Philippines and Indonesia. Moreover, certain special zones have not performed well in attracting FDI due to their remote location (and resulting labour shortages), implementation difficulties and a generally poor investment climate, to varying degrees in the different countries.

The monetary costs arising from government grants and foregone tax revenue can be significant and will need to be offset by tax increases, borrowing or spending cuts elsewhere. Some—albeit limited—attempts have been made to quantify tax revenue losses in some Southeast Asian countries. Studies in Vietnam put the cost of preferential corporate income tax rates at up to US$224 million—or 0.7 per cent of GDP—across the board in 2001 and US$42.3 million in the mining and quarrying industry specifically in 2006. Other studies looking at the cost of redundant incentives estimated a loss in foregone tax revenue of US$770 million in the Philippines in 2004 and a public subsidy of between 62 to 75 per cent in Vietnam. In Indonesia, the cost of redundant incentives in the 1970s was found to have been roughly equivalent to the amount of investment attracted.

These calculations do not take into account the non-monetary benefits that the country can receive from the investments. Perhaps the greatest benefit that countries hope to gain is spillover of technology and know-how to domestic industries. A key determinant for such spillovers to occur is the presence of local capacities. In Singapore and Malaysia—which rank in the world’s top third for their education system, technological readiness, business sophistication and innovation—FDI constitutes an important source of new technologies. At the other end of the spectrum, Cambodia ranks low in both local capacities and influx of new technologies through FDI.

Evidence suggests that spillovers are less likely to occur for export-oriented firms than for those supplying the domestic market. In Thailand, Malaysia and Indonesia, for instance, many overseas companies were found to be operating in “foreign enclaves” with a focus on a limited number of product, little value-added and poor linkages to local suppliers. More recently, due to the progressive opening of the domestic market, some transfers have occurred through the linkages between multinational enterprises (MNEs) and local suppliers as MNEs seek to capitalize on local companies’ ability to better respond to market demands.

In terms of employment generation, statistics suggest that FDI has helped to create jobs in Southeast Asia, in particular where FDI has served to expand the manufacturing sector. However, employment generation has not always been maximized. Where investments have been in capital-intensive sectors, such as mining and hydropower in Laos and Vietnam, employment generation has lagged considerably behind growth in capital inflows. Moreover, emphasis on export-oriented industries and weak local
capacities have limited the linkages and thereby employment opportunities for local suppliers in some countries. Studies on the impacts of FDI on wages and labour standards in Southeast Asia are limited. Some evidence suggests shortcomings in labour relations and human resource development in some export processing zones, such as Malaysia and the Philippines, although others, such as in Singapore, have performed well in this regard.

The environmental impacts of investment incentives are seriously under-researched. Such impacts can occur where investment incentives increase the level of production or where the FDI projects themselves negatively affect the environment, such as in large-scale hydropower, mining or industrial agriculture projects. A FDI-induced growth in manufacturing industries, notably the electronics industry in Thailand and Malaysia, has raised serious environmental concerns related to pollution, high energy consumption and hazardous electronic waste. Concerns have also been raised that foreign enterprises may be attracted to an investment location to take advantage of lax environmental standards or that host governments may lower their environmental standards or fail to enforce them to attract foreign investors. Overall, however, there seems to be growing consensus that for most sectors, environmental standards play a less significant role in influencing FDI decisions than other cost factors.

Incentives and investment competition in Southeast Asia

FDI competition is particularly prevalent among countries within the same geographical region that have comparable factor endowments. Indeed, incentive-based FDI competition—initiated by Singapore and emulated by its neighbours—has been identified as one of the key driving forces behind the proliferation of increasingly generous investment incentives in Southeast Asian countries. Several of the most important FDI sectors in the region are among those where investment competition is most common, including automobiles, petrochemicals, electronics and information technology. Limited evidence from Vietnam also shows that decentralization of government has stimulated incentive-based competition at the sub-national level in the region.

No systematic studies have been carried out to assess the impacts of incentive-based competition on FDI diversion across the Southeast Asian region. A general comparison of FDI sectors, source countries, types of investors, investors’ motivations and the broader investment environment among the Southeast Asian countries suggests that incentives could play a role in diverting FDI between Singapore and Malaysia for high-tech industries as well as among Malaysia, Thailand, Indonesia, the Philippines and Vietnam for manufacturing components and medium-tech products for export. The region’s least-developed countries Cambodia and Laos (as well as Vietnam to a lesser extent) would likely compete for low-tech assembly industries and FDI in natural resource extraction and large-scale agricultural production.

Similarly, evidence on the actual impacts of incentive-based competition on socio-economic and environmental progress is still inconclusive, both globally and for Southeast Asia. Some have argued that competition for mobile capital can be healthy, facilitating the efficient allocation of investment and encouraging governments to improve the investment environment more generally. More commonly, however, concerns have been raised that competition can lead to “bidding wars” that will leave all bidders no better or even worse off in the end. While the proliferation of incentives in Southeast Asia highlights the role that investment competition can play, it is still unclear whether this trend has had positive or negative impacts on the sustainable development of these countries.

Liberalization of Southeast Asia countries’ investment regimes has also been driven by concerns over FDI diversion to China. FDI inflows to China (excluding Hong Kong) did increase markedly in the early
1990s, quickly surpassing investment flows to Southeast Asia. Similarly, China’s share in FDI inflows to Asia grew rapidly during that time, but has more or less stabilized since 1994. While China is likely to have diverted some FDI from Southeast Asia, several analyses have concluded that the “China effect” should not be overestimated. Some econometric studies have suggested that growing FDI inflows to China may in some cases have helped attract investment to the Southeast Asian region, at least at the aggregate level, by providing a market for components from various East and Southeast Asian countries that are then assembled in China. Such impacts appear to have differed among Southeast Asian countries depending on the level of complementarity. Thus, China may have helped attract FDI to the Philippines while diverting FDI from Indonesia and Malaysia.

**Investment incentives in bilateral and regional treaties**

All Southeast Asian countries have concluded a number of bilateral investment treaties (BITs) and/or free trade agreements (FTAs) that include investment provisions. The majority of these agreements have been signed by the more industrialized Southeast Asian countries, including Malaysia, Indonesia, Thailand, Vietnam, Singapore and the Philippines. Some of the main partners include Japan, Korea, China and India, who have entered into investment-related agreements with the majority of Southeast Asian countries individually and are also negotiating investment agreements with the Association of Southeast Asian Nations (ASEAN) as a whole.

While these agreements do not refer to investment incentives specifically, they contain a number of provisions that are relevant in this context. Of particular interest are provisions related to performance requirements. For instance, some of the agreements allow for benefits (referred to as “advantages,” which are left undefined) offered to investors to be conditioned on certain performance requirements that a country may choose to apply to enhance the sustainable development benefits of the investment. Examples include requirements to hire a given level of its nationals or transfer technology. More commonly however, the agreements explicitly prohibit the use of certain performance requirements across the board. Such provisions, in particular where they go beyond the obligations set out in the WTO Agreement on Trade-related Investment Measures (TRIMs), have been criticized for limiting recipient countries’ flexibility to use performance requirements to promote domestic development through linkages by a foreign investment into their wider economy.

At the regional level, Southeast Asian countries adopted the ASEAN Investment Area (AIA) in 1998 (revised in 2001) in an effort to attract investment from within and outside the region. Liberalization efforts were recently strengthened with the conclusion of the ASEAN Comprehensive Investment Agreement (ACIA) in August 2008, which merges and replaces existing ASEAN investment agreements. The ACIA is set to be signed at the 14th ASEAN Summit in early 2009. The new agreement would speed up the liberalization of the investment environment, which is set to be completed by 2015 for all investors. Among the newly introduced provisions, the ACIA would prohibit certain performance requirements and mandates a joint assessment to consider additional requirements.

As the ASEAN region becomes increasingly integrated through the progressive liberalization of investment and trade in goods and services, the likelihood of incentive-based competition for FDI is likely to grow. However, the region has yet to move on adopting related provisions as other highly integrated regions have done. In the longer term, region-wide regulations can help to ensure that investment incentives benefit the region as a whole with a minimum of trade distortion by regulating where, how and how many incentives are provided.
## Acronyms and Abbreviations

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<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tr>
<td>ACIA</td>
<td>ASEAN Comprehensive Investment Agreement</td>
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<td>AIA</td>
<td>ASEAN Investment Area</td>
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<td>AIGA</td>
<td>ASEAN Investment Guarantee Agreement</td>
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<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>BIT</td>
<td>bilateral investment treaty</td>
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<td>CIT</td>
<td>corporate income tax</td>
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<td>EPZ</td>
<td>export processing zones</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<td>FIE</td>
<td>foreign invested enterprises</td>
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<td>FIZ</td>
<td>Free Industrial Zone</td>
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<td>FTA</td>
<td>free trade agreement</td>
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<td>GFCF</td>
<td>gross fixed capital formation</td>
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<td>GIZ</td>
<td>General Industrial Zone</td>
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<td>IISD</td>
<td>International Institute for Sustainable Development</td>
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<td>IPR</td>
<td>intellectual property right</td>
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<td>IPZ</td>
<td>Industrial Promotion Zone</td>
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<td>MNE</td>
<td>multinational enterprise</td>
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<tr>
<td>NIE</td>
<td>newly industrialized economy</td>
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<tr>
<td>PDR</td>
<td>People’s Democratic Republic (Lao)</td>
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<tr>
<td>R&amp;D</td>
<td>research and development</td>
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<td>SME</td>
<td>small- and medium-sized enterprise</td>
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<td>TKN</td>
<td>Trade Knowledge Network</td>
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<td>TRIM</td>
<td>Trade-related Investment Measures</td>
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<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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1 Introduction

Recent decades have seen a proliferation of investment incentives around the world as governments try to attract increasingly mobile foreign direct investment (FDI) in the hope of spurring economic growth, raising employment and bringing technology and know-how to the country. Globalization and economic integration have been the main drivers of this trend. Investment liberalization has facilitated monetary flows between countries and in particular within regions. At the same time, trade liberalization—coupled with advances in production, communication and transportation technologies—has enabled multinational enterprises (MNEs) to develop international production networks with assembly lines spanning a number of countries.\(^1\) These changes have reduced the importance of domestic market size as a prime criterion for investors, thereby providing new opportunities for smaller economies where MNEs can reduce production costs or tap into natural resources.\(^2\)

These developments have meant that investment incentives, which have traditionally been provided primarily by industrialized countries, are now increasingly being offered by developing countries to compete for FDI. Southeast Asia is no exception to that trend. The region has seen a more-or-less steady growth in FDI inflows over the last three decades, reaching $60 billion\(^3\) in 2007, a 15-fold increase compared to the FDI that flowed into the region in 1987. Singapore, which continues to attract the lion’s share of investments, was the first country in the region to aggressively promote FDI. Since then, all Southeast Asian countries have increasingly opened their doors to foreign investors, although the timing and extent of investment promotion has differed between the countries.

The impacts of investment incentives in Southeast Asia, however, remain poorly understood. On the whole, countries with more liberal investment regimes have been more successful in attracting FDI. However, the example of Indonesia shows that investment promotion does not automatically lead to FDI growth. More importantly, the quantity of investments is not a sufficient indicator to judge the success of incentives. Instead, it is necessary to assess the impacts of incentive-induced FDI on the country’s policy objectives related to economic growth, social development and environmental sustainability. Moreover, concerns have been raised that competition for investment within the region and between Southeast Asia and China could lead to a “race to the bottom” where the costs of providing progressively, more generous incentives for FDI end up outweighing its benefits.

This paper aims to inform the development of national and regional policies on investment incentives by reviewing the evidence regarding the impacts of these incentives on FDI decisions and sustainable development in Southeast Asia. It begins with a brief overview of recent trends in FDI inflows to the region and the incentives provided to foreign investors. Drawing on existing research, the paper assesses the impacts of incentives on sustainable development with a focus on economic growth, government revenue, technology and knowledge spillovers, employment, other social impacts and environmental protection. The paper goes on to evaluate to what extent investment competition within Southeast Asia and with China has influenced the evolution of incentive policies in the region. Finally, the paper reviews how Southeast Asian governments have sought to regulate investment incentives through bilateral investment agreements (BITs) and the Association of Southeast Asian Nations (ASEAN).

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\(^1\) ADB (2006)  
\(^2\) Blomström and Kokko (2003)  
\(^3\) Unless otherwise indicated, all $ amounts refer to US dollars.
2 Investment Trends in Southeast Asia

2.1 FDI inflows by volume

Since the late-1980s, FDI inflows to Southeast Asia have increased considerably (Figure 1).\(^4\) A number of external factors have driven this rapid growth, including the appreciation of the Japanese yen and the loss of preferential market access to developed-country markets for Asia’s newly industrialized economies, which resulted in a shift of labour-intensive production to lower-cost producers in Southeast Asia.\(^5\) The 1997 financial crisis led to a temporary decline in overall FDI in the region, but inflows have been increasing steadily since 2002. While the external environment has greatly influenced overall FDI inflows, the distribution of FDI within the region has largely been attributed to the policies in each country.\(^6\)

Figure 1: Total FDI inflows to Southeast Asia (1970–2007) (billion $)

Singapore, due to the extensive liberalization of the investment regime since the early 1960s, has almost consistently attracted the largest share of regional FDI, accounting for almost half of total investments between 2000 and 2007 (Figure 2 and Figure 3). Thailand and Malaysia were able to benefit the most from the relocation of manufacturing companies in the late-1980s. While Malaysia attracted in particular export-oriented companies, Thailand also became an important destination for investors seeking to capitalize on domestic market opportunities.\(^7\) The oil and gas sector initially drove FDI inflows to Indonesia. Investments plummeted in the late-1990s due to political instability, but started recovering in the mid-2000s. For the most part, FDI to Vietnam remained steady, but relatively low, between the mid-1990s and the middle of this decade, but saw a three-fold jump in 2007 (compared

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\(^4\) For the purpose of this paper, Southeast Asia refers to the member states of the Association of Southeast Asian Nations (ASEAN), including Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

\(^5\) Thomsen (1999).

\(^6\) Ibid.

\(^7\) Ibid.
with 2006 inflows) following the country’s accession to the World Trade Organization (WTO) and the implementation of investment liberalization measures. FDI inflows to the Philippines were generally low and erratic in the 1980s due to economic and political instability. Inflows expanded in the 1990s, but remain comparatively low. The remaining Southeast Asian countries, including Cambodia, the Lao People’s Democratic Republic (PDR) and Myanmar, have only attracted a minor share of regional FDI, largely as a result of shortcomings in the overall investment environment, such as poor infrastructure, high electricity costs and low education levels.

Figure 2: FDI inflows to Southeast Asia by country (1987–2007) (billion $)

* Other countries in include the Philippines, Vietnam, Cambodia, the Lao PDR, Brunei Darussalam and Myanmar.
Source: UNCTAD (2008)

To better understand the role of FDI in the local economy vis-à-vis domestic investment, it is useful to look at FDI inflows as a percentage of gross fixed capital formation (GFCF; Figure 4). In Singapore, FDI’s share of GFCF averaged around 44 per cent annually over the past 20 years. The average, however, hides significant fluctuations, ranging from 23 per cent in 1998 to as much as 80 per cent in 2006, reflecting the lumpiness of large investments. The share of overseas investments has been lower and somewhat less volatile in Malaysia and the Philippines, hovering around 16 and 9 per cent respectively, on average over the past 20 years. In Thailand and Indonesia, the role of foreign investment in acquiring fixed assets was for the most part minor until the 1997 financial crisis, which saw a dramatic drop in FDI’s share in Indonesia (likely due to flight of foreign capital during the political turmoil in the late 1990s) and a significant jump in Thailand. FDI’s share in Thailand’s GFCF returned to around 15 per cent annually in the 2000s, but in

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7 Ibid.
8 UNCTAD (2008).
10 GFCF: the value of additions to fixed assets (such as machinery, land improvements, buildings or vehicles) purchased by business, government and households less disposals of fixed assets sold off or scrapped.
Indonesia the percentage remains below 10 per cent. While investment flows to Vietnam, Cambodia and the Lao PDR have been comparatively minor, they provide a substantial share of overall investment in fixed assets, in particular in the early- to mid-1990s, which saw the share increase to about half of GFCF in Vietnam and around 60 per cent Cambodia and the Lao PDR. The share fell below 25 per cent in 2000 in all three countries, but has since recovered to varying degrees.

Figure 3: Share of FDI to Southeast Asia by recipient country (total of 2000–2007)

* Other countries include Cambodia, the Lao PDR, Brunei Darussalam and Myanmar.
Source: UNCTAD (2008)

Figure 4: Share of FDI as a percentage of gross fixed capital formation (1987–2007) (per cent)
The Inward FDI Performance Index calculated by the United Nations Conference on Trade and Development (UNCTAD), which ranks countries by the FDI they receive relative to their economic size, provides yet another indicator of how well countries have done in attracting FDI (Figure 5). Comparing...
selected Southeast Asian countries in terms of inward FDI performance shows that Singapore, Malaysia and, a little later, Vietnam succeeded in attracting significant amounts of FDI relative to their market size in the late 1980s and early 1990s, but their performance indices dropped considerably as a result of the 1997 financial crisis (although less so in Singapore). The FDI performance of Thailand and the Philippines has been low, but comparatively more stable over the years. Indonesia’s performance, already low prior to 1997, suffered most from the financial crisis, exacerbated by the political crisis in the late 1990s and early 2000s.

2.2 FDI inflows by source countries

Between 1995 and 2004, around a third of FDI to the Southeast Asian region came from European investors, followed by investors from the US and Japan (Figure 6). A sizeable share of FDI (13 per cent) is intra-regional, primarily from Singapore (63 per cent) as well as Malaysia and Indonesia (16 and 13 per cent respectively).

Figure 6: Share of FDI inflows to Southeast Asia by source country (1995–2004)

The composition of source countries for FDI differs among the Southeast Asian economies (see Table A.1, Annex 1, for 1994–2005 data). As a result of the relocation of manufacturing capacity within the region, as mentioned above, Japan is an important investor for Southeast Asia’s economically more advanced countries. The majority of Singapore’s FDI originates from OECD countries. Thailand and Malaysia receive substantial investments from Singapore, Japan, the EU and the U.S. While U.S. investors have traditionally been most active in the Philippines and continue to play an important role, regional investors, including Japan, Singapore and the region’s newly industrialized economies (NIEs) Korea, Hong Kong and Taiwan, have also gained in importance. In contrast, European investors are prominent in Indonesia in order to gain access to the country’s oil and gas resources, while the country has seen a substantial net outflow of FDI by U.S. investors since the 1997 financial crisis. In Vietnam, Japan, the NIEs and the EU dominate FDI inflows. The NIEs are also important investors in Cambodia, along with Malaysia and, increasingly, China, which provided half of FDI inflows to the country between 2001 and 2004 (primarily in the garment industry). In the Lao PDR, Southeast Asian countries continue to provide the largest share of FDI while investments from Korea have been

Note: Data do not include the source country distribution of reinvested earnings and intra-company loans of the Philippines and Singapore. The data reported by Cambodia between 1995 and 2000 were on an aggregate basis and are therefore not included in this calculation.

Source: ASEAN Statistical Yearbook 2005

11 See also ADB (2006); Thomsen (1999); and Banga (2003).
decreasing. At the same time, the role of developed countries, and to a lesser extent China, has been growing so as to access the country’s natural resources and agricultural land.

2.3 FDI inflows by sector

The manufacturing sector attracted the largest share of FDI inflows to Southeast Asia between 1999 and 2003, constituting between 27 and 40 per cent of total FDI to Singapore, Thailand, Malaysia, the Philippines, the Lao PDR and Vietnam (Figure 7 and Table A.2, Annex 1). By contrast, Indonesia saw massive net outflows of FDI in this sector, and to a lesser extent, in services. Financial services were the second most important sector for FDI to the region, primarily in Singapore. Trade and commerce also managed to attract a substantial share of FDI in Singapore and Thailand while playing a minimal role in the other Southeast Asian countries. FDI in the mining and quarrying sector made up about a quarter of FDI to Malaysia, Vietnam and the Lao PDR respectively, while the sector accounted for the vast majority of FDI in Brunei and Myanmar (although actual FDI in Myanmar is very small). FDI in the agriculture, fisheries and forestry sector was minimal for most Southeast Asian countries, with the exception of Vietnam and the Lao PDR, although the sector’s share is still relatively small.

Figure 7: Share of FDI inflows to Southeast Asia by sector or industry (1999–2003)

Note: Data do not include the sectoral distribution of reinvested earnings and intra-company loans of the Philippines. The data reported by Cambodia were on an aggregate basis and are therefore not included in this calculation.

Source: ASEAN (2005)
3 Overview of Investment Incentives in Southeast Asia

All Southeast Asian governments offer a range of incentives to attract investments (see Box 1 for an overview of investment incentives). Such measures are motivated by a number of policy objectives. Governments may provide FDI incentives in an effort to help finance economic expansion and diversification without having to add to the external debt burden where domestic savings or overseas development assistance are insufficient. Incentives can also be used to address economic distortions caused by a structure of protection, for instance by allowing for duty-free imports of intermediate inputs for export-oriented industries to compensate for high tariffs on imports of intermediate or capital goods. In addition, countries with weak investment climates may provide incentives to compensate investors for the perceived risk of investing in the country.

In addition, incentives aim to attract FDI with the hope of creating spillovers (or positive externalities) for the host economy. Such spillovers include in particular the transfer of technology and know-how to domestic industries, as well as assisting in enterprise development and restructuring, stimulating competition in the local business sector and enhancing the productivity of domestic firms. Other developmental objectives include stimulating investments in disadvantaged areas, generating employment opportunities for the domestic workforce and increasing tax revenues. In this context, incentives may not only be important for their actual impacts, but also to demonstrate that concrete efforts are being made to attract FDI.

Box 1: Overview of investment incentives

For the purpose of this paper, investment incentives are defined as measures designed to influence the size, location or industry of an investment project by affecting the relative cost or by altering the risks attached to the investment project. Incentives can be provided both at the national and at the sub-national levels, either automatically (to qualifying investors) or on a discretionary basis. Incentives are generally categorized into three types*, namely:

- **Fiscal (or tax) incentives**, such as tax holidays, special tax-privileged zones, special investment allowances, investment tax credits and reductions in corporate income tax, import taxes, customs duties, sales tax or VAT
- **Financial incentives**, such as infrastructure subsidies or job training subsidies, subsidies for meeting relocation costs, credits to investors or the provision of land at below market value
- **Regulatory incentives**, i.e., derogations from national or sub-national rules and regulations often to ease the environmental, social and labour-market related requirements placed on investors

These measures can be targeted at different investors:

- **General measures**, such as a lower rate of corporate income tax than other countries competing for the same investments, seek to increase investments overall from both domestic and foreign investors.
- **Some governments also provide incentives to attract foreign direct investment specifically**, such as tax holidays available only to foreign investors.
- **Other incentives are targeted at attracting investment to a specific sector, activity or region or aim to build on a particular comparative advantage** (such as low labour costs). Incentives are provided both at the national and at the sub-national levels, either automatically (to qualifying investors) or on a discretionary basis.

* see OECD (2003)

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12 OECD (2003).
14 OECD (2003).
Singapore began to aggressively promote FDI in the early 1960s, providing increasingly generous incentives to foreign investors (see Annex 2 for an overview of selected investment incentives provided by Southeast Asian countries).\(^{15}\) In 2006, the country was ranked as offering the most attractive investment incentives in the world.\(^{16}\) Initially, emphasis was placed on promoting industrialization and attracting labour-intensive industries to generate employment. As the gap between FDI and domestic savings began to close in the 1980s, a “Second Industrial Revolution” was launched to increase technological sophistication by attracting high-tech, high-skill, capital-intensive industries. Most recently, Singapore sought to shift to a knowledge-based economy with an emphasis on strengthening the knowledge infrastructure, and human and intellectual capital.\(^{17}\)

Following Singapore’s lead, other countries in the region have quickly followed suit. Malaysia and Thailand, which began providing generous incentives in the late 1960s and early 1970s respectively, ranked among the developing countries most open to FDI for many years.\(^{18}\) While both countries focused on import substitution in the 1960s, attention soon shifted to the promotion of investment in export-oriented manufacturing, notably in the electronics industry (and in the case of Thailand automobiles) in an effort to create jobs and promote economic growth, in particular in disadvantaged regions. The mid-1980s saw a renewed push for attracting such investments to capitalize on the relocation of manufacturing industries from Asia’s NIEs. Since the 1997 financial crisis, both countries have begun also to open up the domestic market for overseas investors.

The Philippines first started offering limited incentives in the late 1960s, but serious efforts to attract FDI only began in the 1990s aimed at expanding exports, stimulating economic growth and generating technology and knowledge spillovers from FDI.\(^{19}\) While Indonesia also introduced investment incentives in the late 1960s, tax incentives only available to foreign investors were abolished in 1984.\(^{20}\) Various incentives were again introduced in the mid-1990s, including substantial relaxation of limits on foreign equity, and the country opened up previously closed sectors and began offering tax benefits in selected sectors, targeting both foreign and domestic investors.\(^{21}\)

In contrast, Cambodia, the Lao PDR, and Vietnam only started opening up to FDI in the 1980s. Vietnam’s incentives have evolved considerably over the past 20 years, shifting from an initial focus on foreign investors to targeting both domestic and foreign investors since 2005.\(^{22}\) Cambodia provides generous incentives to foreign and increasingly also to domestic investors, while selectively applied incentives provided in the Lao PDR are targeted primarily at foreign investors.\(^{23}\)

The most widely available incentives in Southeast Asian countries are tax incentives, usually granted for a defined period and with certain eligibility criteria, and reduced duties on capital goods and raw materials used in export-oriented production. For instance, all ASEAN countries provide tax holidays for investors, ranging from three to 10 years with some restrictions. Some countries also apply reduced

\(^{15}\) Chia and Whalley (1995).
\(^{16}\) IMD (2007).
\(^{17}\) Lim and Lim (2009).
\(^{18}\) See Thomsen (1999); Oman, C. (2000).
\(^{19}\) Chia and Whalley (1995); Thomsen (1999); Aldaba (2006).
\(^{20}\) Wells et al. (2001).
\(^{21}\) Adiningsih et al. (2009).
\(^{22}\) Vu et al. (2009).
\(^{23}\) ADB (2006).
corporate income rates, although these are usually confined to certain zones or sectors. Similarly, most countries provide exemptions or reduced import duties and/or VAT rates on inputs, in particular for export-oriented production.

All Southeast Asian countries have set up special areas in the form of industrial zones, export processing zones, special economic zones and industrial parks, where investors can benefit from special tax benefits and refunds as well as from support from the government to finance infrastructure and set up streamlined administrative procedures (see also Table 1, Section 4.1.1). Singapore, Malaysia, Indonesia and the Philippines set up special zones already in the early 1970s while Thailand followed suit in the early 1980s. Vietnam opened its first export-processing zones in the mid-1990s. Cambodia adopted a legal framework for special economic zones (including industrial and export processing zones) in 2005 and is planning to develop 10 zones, one of which is operational so far. The Lao PDR’s only special economic zone is still being developed.

Some of Southeast Asia’s incentives are aimed at promoting investments in certain regions. Thailand, for instance, has divided the country into three zones based on their proximity to Bangkok in an effort to reduce concentration of FDI in the Bangkok area, with the most generous tax incentives granted to investors located in the zone furthest from Bangkok (e.g., longer income tax holidays). Malaysia grants tax holidays of five years on 85 per cent of statutory incomes to projects in promoted areas. The Lao PDR encourages investments in less developed areas by providing longer tax holidays to investment projects in areas where there is as yet only a limited economic infrastructure. Vietnam has identified specific locations with difficult socio-economic conditions where investors will be eligible for investment incentives.

Other measures are targeted at attracting investments to certain types of industries and sectors. Beginning in the mid-1980s, Malaysia and Thailand, for instance, sought to attract FDI to promote exports while placing restrictions on foreign investor access to the domestic market (these restrictions were loosened following the 1997 financial crisis). In addition, Malaysia, Thailand and Indonesia have identified priority activities that are eligible for investment incentives, with preference given to export production and opportunities for technology transfer. Similarly, Vietnam has drawn up two lists of sectors that are eligible for two types of incentive schemes. More generous incentives are granted to, among others, high-tech industries, certain agricultural activities, labour-intensive industries and infrastructure development. In the Philippines, foreign firms producing for the domestic market will only be eligible for incentives if they are engaged in “pioneer activities” that are important to national economic development in an effort to prevent displacement of local companies by foreign producers.

27 See http://www.hasil.org.my/english/eng_NO2_5_2.asp (accessed 12-12-08).
29 Vu et al. (2009).
30 Thomsen (1999).
31 Vu et al. (2009).
Other incentives are meant to promote value addition and the transfer of technology and know-how. Vietnam, for instance, encourages high-tech investments by providing the greatest tax benefits to investors in high-tech zones.\(^{33}\) Also, companies with technology transfer activities are entitled to multiple incentives, including access to the national Technology Innovation Fund and corporate income tax (CIT) exemption for four to nine years.\(^ {34} \) Malaysia’s Multimedia Super Corridor initiative was launched in 1996 in an effort to transform the nation into a knowledge-based economy. It promotes investment in the information and communication industries by offering a range of incentives to qualifying companies that include, among others, tax benefits, research and development grants, duty-free importation of multimedia equipment and upgrading of physical and communications infrastructure.\(^ {35} \) In addition, Malaysia’s Industrial Linkage Programme uses incentives to encourage linkages between MNEs and local small- and medium-sized enterprises (SMEs), such as tax refunds for MNE’s expenditures on training or factory auditing.\(^ {36} \) The Philippines provides tax credits on domestic capital equipment for import substitution of raw materials used in producing non-traditional exports in order to encourage backward linkages to domestic suppliers.\(^ {37} \)

In addition to positive incentives, several countries have imposed certain restrictions to ensure employment opportunities for local workers and limit access to sensitive sectors. Vietnam, for instance, caps the share of foreign employees at three per cent of the company’s total workforce. Foreign equity limits have also been imposed by some countries. The Lao PDR, for instance, has excluded mining and energy projects from 100 per cent foreign ownership. Vietnam has identified 35 business sectors where local companies may issue shares to foreign investors, with a cap of 49 per cent on foreign ownership.\(^ {38} \) In the Philippines, foreign equity for non-pioneer activities targeting the domestic market is limited to 40 per cent unless domestic capital proves inadequate to meet the desired industry capacity.\(^ {39} \) In addition, the Philippines has identified a negative list of sectors where foreign investment is restricted below 100 percent, including sectors falling under the Constitution or those with restrictions mandated under various laws. Indonesia and Thailand have also specified “negative” lists of sensitive sectors where foreign investors are excluded or subject to restrictions.\(^ {40} \) As these countries have liberalized their investment regimes, these negative lists have become progressively shorter.

\(^{33}\) Vision (n.d.).
\(^{34}\) Vu et al. (2009).
\(^{35}\) See http://www.mscmalaysia.my/ for further details (accessed 14-10-08).
\(^{36}\) MIDA (2008).
\(^{38}\) ADB (2006).
\(^{39}\) Aldaba (2006).
\(^{40}\) Thomsen (1999).
4 Investment Incentives, FDI and Sustainable Development

While the use of investment incentives is widespread in Southeast Asia, their actual impacts on foreign investors' decision about where to invest, in what and how much remain poorly understood. The impact of these decisions on economic growth, social development and environmental sustainability also remain poorly understood. Existing studies, which have primarily focused on developed countries, tend to examine direct economic impacts (such as impacts on FDI volumes and efficiency), while only a few analyses have attempted to assess broader socio-economic and environmental impacts. Understanding such impacts can be challenging due to difficulties in assessing the costs and benefits of investment incentives and isolating the role of incentives from other factors.

In particular in developing countries, incentive schemes and their costs are not always transparent. Even where the information is relatively accessible, understanding the real costs of investment incentives can be complex. The calculation would not only need to look at direct payments or decreases in government revenue, but also take into account whether the investment would have happened without or with less costly incentives. Opportunity costs would also need to be assessed, i.e., whether the funds used to finance the incentives could have been used more profitably somewhere else. Where incentives lead to inefficiencies—for instance by attracting companies to produce in inefficient locations—wider economic costs can arise. Moreover, the costs and benefits of incentives are often spread out over time, in which case they would need to be calculated in terms of present value. Costs may also arise where incentives favour new investors over established ones, thereby encouraging established investors to leave or engage in “round-tripping” (i.e., invest overseas to then return as a “new” investor). In addition, investments incentives, where they are not supported by a sound economic and regulatory environment, might expose countries to rent-seeking behaviour and increase the risk of corruption. Finally, governments also need to consider the administrative costs of managing incentive schemes.

Isolating and quantifying the causal linkages between incentives, FDI decisions and sustainable development impacts is even more challenging. As will be discussed below, the impacts of investment incentives are influenced by a whole range of factors related both to the investment environment (such as market size, education levels, infrastructure, political stability or trade policies) and the investors (including the home country, size, sector or market orientation). Again, considering the counterfactual will be important—i.e., what would have happened if the incentive had not been provided? Adding to the complexity is that incentives need to be considered as a package, not individually, and be compared with the attractiveness of investment incentive packages in other jurisdictions.

These challenges are compounded by a lack of monitoring in most countries to evaluate the costs and benefits of incentive schemes and enforcement mechanisms to ensure that investors’ promises and obligations are met. However, understanding these complex interactions will be crucial if investment incentives are to meet their stated policy objectives. The following section will review available evidence regarding some of the economic, social and environment impacts of investment incentives in Southeast Asia.

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41 Thomas (2007).
42 See Banga (2003); Thomas (2007); OECD (2003); and Oman (2000) for discussions of these challenges (summarised in the following paragraphs).
4.1 Impacts of incentives on FDI decisions and sustainable development in Southeast Asia

4.1.1 FDI inflows and economic growth

Investment incentives aim, among other policy objectives, to influence the volumes of FDI that flow into the country or province in order to make up for shortfalls in domestic savings. Given the challenges mentioned above, causality between incentives and FDI inflows is difficult to establish. Also, the jury is still out on the relative importance of incentives vis-à-vis other factors related to the investment environment. While earlier studies generally concluded that the role of incentives was only minor compared with other factors, more recent assessments suggest that investment incentives might be gaining in importance.43

Indeed, in Singapore, Malaysia and Thailand, investment incentives have been credited with having played a major role in attracting FDI, which in turn has been a significant source of economic growth.44 In Thailand, for instance, foreign investors, notably in the electronics industry, significantly contributed to rapid export expansion, which became the main engine of economic growth in the 1980s. While export growth would likely have happened even without the presence of foreign investors, foreign invested enterprises (FIEs) greatly accelerated that process. Similarly, Cambodia’s rapid expansion of the Chinese-dominated garment industry (from no factories in 1995 to 250 in 2005) has sustained economic growth, contributing 70 per cent of the whole manufacturing sector’s value-added in 2005 and 75 per cent of total exports.45

However, experiences have also shown that incentives are certainly not a sufficient condition for attracting FDI and a number of other factors will be important in shaping FDI decisions (see also Section 4.2). For instance, Fletcher found little evidence for a positive relationship between incentives and FDI flows after plotting FDI as a share of GDP against a “tax incentive index” for several East Asian countries.46 In the case of Vietnam, special incentives linked to export performance requirements failed to attract significant investments in heavy industries, such as chemicals, metal products and motor vehicles.47 The Philippines has yet to attract significant investments even after bringing its investment incentives up to par with its neighbours Thailand, Indonesia and Malaysia (albeit only recently).48 In Indonesia, FDI contracted considerably in the late-1990s despite the availability of investment incentives, primarily due to political instability.

Generalizations regarding the impacts of investment incentives on FDI decisions are of course overly simplistic. For instance, the effectiveness of incentives is likely to vary depending on the characteristics of the investors. Assessing FDI data from Southeast, South and East Asia, Banga finds that FDI incentives appear to play a greater role in attracting investments from developing countries, while the removal of restrictions on companies’ operations seem to be a more important deciding factor for investors from developed countries.49

44 Thomsen (1999).
45 EIC (2007).
46 Fletcher (2002).
49 Banga (2003).
more prominent in economically more advanced (or rapidly advancing) countries such as Malaysia, Singapore, Indonesia, Thailand, the Philippines and Vietnam, while much of the FDI to Cambodia and (to a lesser extent) the Lao PDR originates from the Southeast Asian developing countries.

Other relevant characteristics include market orientation, size and the sector that the FIE is seeking to invest in. One study found that tax incentives played a far greater role for export-oriented firms than for those wanting to access the domestic market or capitalize on local advantages, given that exporters tend to operate on very slim margins. Tax incentives were also found to be more important for small investors than for large ones. New firms, in turn, will be more interested in incentives to reduce initial expenses, while expanding firms favour tax benefits on profits.

In Vietnam, general assessments of the importance of investment incentives concluded that such incentives appeared to have played a minor role in affecting FDI decisions. A recent survey of FIEs investing in Vietnam's mining sector showed that investors rated investment incentives, in particular tax benefits, as one of the two most important factors affecting their investment decision (along with the legal framework), since investments in mining projects required huge capital and carried high risks. However, the majority of investors added that they would have made the investments even without the incentives due to Vietnam's comparatively low natural resource royalties and labour costs.

With regard to the performance of export processing zones (EPZ), a study by the International Labour Organisation on labour and social issues in EPZs in a number of countries (including, among others, Malaysia, the Philippines and Singapore) found that on the whole, these zones had indeed succeeded in attracting significant amounts of investment, in particular in labour-intensive, export-oriented industries. By 2007, Malaysia's 13 Free Industrial Zones were contributing 83 per cent of total exports while the economic zones in the Philippines made up 60 per cent of total exports (Table 1).

Table 1: Export Processing Zones in selected Southeast Asian countries

<table>
<thead>
<tr>
<th>Country</th>
<th>No. of EPZs</th>
<th>Other types of zone</th>
<th>Total employ. (2005–06)</th>
<th>Investment ($)</th>
<th>Zone exports (million $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>7 EPZ</td>
<td>35 (industrial parks)</td>
<td>6,400 million</td>
<td>165.9 million</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>13 (FIZ)</td>
<td>200 (industrial and hi-tech parks)</td>
<td>369,488+ 122,000 (54% women)</td>
<td>12.6 billion (83% of total exports)</td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>10 EPZ</td>
<td>22 GIZ &amp; IPZ</td>
<td>451,599</td>
<td>8.242 billion</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td></td>
<td>Bonded zone</td>
<td>1,128,197 (74% women)</td>
<td>32.030 billion (60% of total exports)</td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>4 public EZs</td>
<td>31 info tech park and buildings, 1 Eastbay arts, recreation and tourism zone, 1 ecozone facilities enterprises warehousing</td>
<td>1,128,197 (74% women)</td>
<td>32.030 billion (60% of total exports)</td>
<td></td>
</tr>
<tr>
<td>Vietnam</td>
<td>10 (EPZ)</td>
<td>8 (EZs) and 173 other type zones</td>
<td>950,000 (45% women)</td>
<td>1,067 million</td>
<td></td>
</tr>
</tbody>
</table>

EPZ: Export Processing Zone, FIZ: Free Industrial Zone, GIZ: General Industrial Zone, IPZ: Industrial Promotion Zone
Source: Singa Boyenge (2007)

51 One study in Vietnam found that 85 per cent of surveyed firms that received CIT incentives would definitely or probably have made the same investment decision even without the incentives (Nguyen et al., 2004). An econometric analysis of different factors influencing FDI decisions in Vietnam confirmed this conclusion, highlighting that other factors, such as good infrastructure, human resources and skilled labour, were more important (Vu et al., 2007).
52 Vu et al. (2009).
However, not all EPZs will necessarily perform well in attracting FDI. In Vietnam, for instance, two EPZs saw significant increases in investments between 1995 and 2003 despite an overall decline in FDI inflows to the country. However, the remaining EPZs performed poorly, one due to its remote location (and resulting labour shortages) and the others due to implementation difficulties. In Cambodia, only one of ten special economic zones has managed to attract a small number of companies, due in part to the slow progress in developing the infrastructure in some of the other zones and Cambodia’s generally poor investment climate, which continues to deter some investors.

4.1.2 Government revenue

As discussed above, investment incentives impose various direct and indirect costs. The most obvious costs are government grants and foregone tax revenue, which need to be offset by tax increases, borrowing or spending cuts elsewhere. In general, incentive schemes tend to be hard to track down, especially where transparency is poor and administrative systems are weak. Nevertheless, some, albeit limited, attempts have been made to quantify tax revenue losses in some Southeast Asian countries.

Fletcher found that the Vietnamese government would have received at least an additional $76 million in 2001 if it had charged foreign investors the standard rather than the preferential CIT rate. He concluded also, based on a different calculation comparing CIT payments by FIEs to payments by domestic companies, that revenue losses might have been even higher at $224 million or 0.7 per cent of GDP. A more recent study puts the value of CIT incentives provided to the mining and quarrying industry in Vietnam at $98.7 million in 2004 and $42.3 million in 2006. A study in Malaysia estimated the forgone surtax and sales tax revenues at around $2.4 billion in 1996 which translates to ca. $30,000 per job created by FDI.

While these numbers provide some indication of the magnitude of revenue losses involved, they say little about whether the monetary benefits that the country received from the investments managed to compensate for the revenue losses. One way of estimating this balance is by looking at the redundancy rate (i.e., would investors have invested anyway even in the absence of incentives?). The few studies that have been carried out in Southeast Asia suggest that the losses can be substantial. A study in the Philippines found that, in 2004, 80 per cent of incentives granted by the Philippine Board of Investments were redundant, amounting to an estimated foregone revenue of PHP 43.2 billion (approximately $770 million in 2004 dollars). Another study for Indonesia suggests that in the 1970s the cost of attracting investments (based on a redundancy rate of 70 percent) was roughly equivalent to the amount of investment attracted. A study in Vietnam estimated the redundancy rate of CIT incentives at around 83 percent, resulting in a public subsidy of between 62 to 75 per cent (i.e., the amount of CIT revenue foregone as a percentage of the additional investment made as a result of the CIT incentive).

54 ADB (2006).
56 Thomas (2007).
57 Fletcher (2002).
58 Vu et al. (2009).
61 Wells et al. (2001).
62 Nguyen et al. (2004).
4.1.3 Spillover of technology and know-how

Perhaps the greatest benefit that countries hope to gain from foreign investments is a spillover of technology and know-how to domestic industries. This can occur through a number of channels, such as when foreign companies build local capacities by introducing new technologies and training employers or where the presence of more advanced MNEs stimulates competition and thereby increases the productivity of local companies. A number of Southeast Asian countries have put in place measures which aim, explicitly or implicitly, to build indigenous capabilities, such as Malaysia’s Industrial Linkages Programme, requirements for joint ventures or limits on expatriate personnel (as described above).

The importance of FDI as a source of new technologies differs among the Southeast Asian countries, as highlighted in the rankings for “FDI and technology transfer” in the World Economic Forum’s Global Competitiveness Report (Table 2). In the case of Singapore and Malaysia, FDI constitutes an important source of new technologies, with Singapore attracting the highest score globally. Indonesia also scores relatively high (possibly due to the large presence of European investors in the country), while the Philippines, Thailand and Vietnam come in at around 50 (out of 134 countries ranked). In Cambodia, FDI is thought to have brought relatively few new technologies.

International evidence on the presence of spillovers from FDI has been mixed. What has become clear, however, is that spillovers are not an automatic consequence of FDI, but that the likelihood of technology and knowledge transfers to occur is influenced by a number of investor and recipient country characteristics. A key determinant relates to the presence of local capacities. Factors such as the educational level of the local labour force, research and development capacities and local firms’ ability and motivation to invest in absorbing foreign technologies and skill have been identified as important prerequisites. A review of selected rankings by the Global Competitiveness Report shows that the Southeast Asian countries vary considerably in this regard (Table 2). Singapore and Malaysia consistently rank in the world’s top third for their education system, technological readiness, business sophistication and innovation. The scores for the Philippines, Thailand, Vietnam and Indonesia are more diverse with average rankings across the indicators. Cambodia trails far behind, ranking low in almost all areas.

Interaction is also facilitated if domestic firms are already active in the MNE’s sector or at least in a related sector with transferable skills. In Indonesia, a study found evidence of intra-industry spillover at the national level. While the study also found spillovers between industries, these are more likely to occur if foreign and local companies are located in the vicinity of one another. Moreover, competition from local producers can stimulate technology and knowledge transfer to local affiliates to allow MNE’s to compete more effectively in the local market.

64 Ibid.
65 See, for example, Blomström and Kokko (2003); Thomsen (1999); OECD (2005).
Table 2: Selected competitiveness rankings in Southeast Asia

<table>
<thead>
<tr>
<th>Factor</th>
<th>Singapore</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Thailand</th>
<th>Vietnam</th>
<th>Indonesia</th>
<th>Cambodia</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Overall rank (out of 134)</strong></td>
<td>5</td>
<td>21</td>
<td>55</td>
<td>34</td>
<td>39</td>
<td>70</td>
<td>109</td>
</tr>
<tr>
<td><strong>Efficiency enhancers</strong></td>
<td>2</td>
<td>24</td>
<td>68</td>
<td>36</td>
<td>73</td>
<td>49</td>
<td>115</td>
</tr>
<tr>
<td>Higher education and training</td>
<td>8</td>
<td>35</td>
<td>60</td>
<td>51</td>
<td>98</td>
<td>71</td>
<td>127</td>
</tr>
<tr>
<td>Quality of the educational system</td>
<td>2</td>
<td>18</td>
<td>46</td>
<td>53</td>
<td>120</td>
<td>39</td>
<td>112</td>
</tr>
<tr>
<td>Local availability of research and training services</td>
<td>13</td>
<td>27</td>
<td>51</td>
<td>58</td>
<td>76</td>
<td>43</td>
<td>115</td>
</tr>
<tr>
<td>Technological readiness</td>
<td>7</td>
<td>34</td>
<td>70</td>
<td>66</td>
<td>79</td>
<td>88</td>
<td>123</td>
</tr>
<tr>
<td>Availability of latest technologies</td>
<td>14</td>
<td>29</td>
<td>52</td>
<td>50</td>
<td>71</td>
<td>61</td>
<td>109</td>
</tr>
<tr>
<td>Firm-level technology absorption</td>
<td>13</td>
<td>21</td>
<td>49</td>
<td>61</td>
<td>54</td>
<td>65</td>
<td>106</td>
</tr>
<tr>
<td>FDI and technology transfer</td>
<td>1</td>
<td>6</td>
<td>50</td>
<td>48</td>
<td>57</td>
<td>24</td>
<td>94</td>
</tr>
<tr>
<td><strong>Innovation and sophistication factors</strong></td>
<td>11</td>
<td>23</td>
<td>67</td>
<td>46</td>
<td>71</td>
<td>45</td>
<td>112</td>
</tr>
<tr>
<td>Business sophistication</td>
<td>14</td>
<td>22</td>
<td>57</td>
<td>46</td>
<td>84</td>
<td>39</td>
<td>110</td>
</tr>
<tr>
<td>Local supplier quantity</td>
<td>44</td>
<td>16</td>
<td>77</td>
<td>25</td>
<td>79</td>
<td>50</td>
<td>126</td>
</tr>
<tr>
<td>Local supplier quality</td>
<td>22</td>
<td>32</td>
<td>64</td>
<td>40</td>
<td>97</td>
<td>57</td>
<td>117</td>
</tr>
<tr>
<td>Innovation</td>
<td>11</td>
<td>22</td>
<td>76</td>
<td>54</td>
<td>57</td>
<td>47</td>
<td>112</td>
</tr>
<tr>
<td>Capacity for innovation</td>
<td>19</td>
<td>21</td>
<td>63</td>
<td>64</td>
<td>41</td>
<td>53</td>
<td>107</td>
</tr>
<tr>
<td>Quality of scientific research institutions</td>
<td>13</td>
<td>20</td>
<td>86</td>
<td>57</td>
<td>85</td>
<td>39</td>
<td>120</td>
</tr>
<tr>
<td>Company spending on R&amp;D</td>
<td>10</td>
<td>18</td>
<td>47</td>
<td>54</td>
<td>42</td>
<td>34</td>
<td>75</td>
</tr>
<tr>
<td>University-industry research collaboration</td>
<td>5</td>
<td>20</td>
<td>63</td>
<td>38</td>
<td>70</td>
<td>54</td>
<td>106</td>
</tr>
<tr>
<td>Availability of scientists and engineers</td>
<td>22</td>
<td>24</td>
<td>92</td>
<td>56</td>
<td>51</td>
<td>31</td>
<td>126</td>
</tr>
</tbody>
</table>

Note: No rankings are available for the Lao PDR and Brunei.
Source: WEF (2008)

Also, evidence suggests that spillovers are less likely to occur for export-oriented firms than for those supplying the domestic market. Export-oriented companies tend to create limited backward linkages to the local economy, instead relying on imports of inputs, partly facilitated by reduced import duties on raw materials for export production. In Singapore, Indonesia, Malaysia and Thailand, for instance, imported parts constituted between 26 and 95 per cent in the foreign-dominated electronics sector in 1994.68 Similarly, the vast majority of raw materials for the Cambodian garment industry, including textiles and semi-finished garment products, are imported from other Asian countries due to limited local supply capacities.69

Similarly, the ILO study on export processing zones found that backward and forward linkages to the wider economy had been limited. Instead, EPZ had created an “industrial monoculture” with economic activity focused on assembly and processing of imported inputs. Singapore marked an exception to this trend owing to the country’s proactive investment strategy aimed at attracting FDI best suited to its economic situation and the development of incentives, infrastructure and government support services needed to implement the strategy.

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68 Thomsen (1999).
69 EIC (2007).
70 Thomsen (1999).
In general, spillovers are more likely to occur where foreign companies target the local market. In Thailand, Malaysia and Indonesia, for example, several studies carried out in the 1980s when access to the domestic market was still highly restricted concluded that spillovers had been minimal. Instead, many foreign companies were operating in “foreign enclaves” with a focus on a limited number of products, little value-added and weak links to local suppliers. More recently, due to the progressive opening of its domestic market some transfers have occurred through the linkages between MNEs and local suppliers as MNE’s seek to capitalize on local companies’ abilities to more quickly respond to market demands.

In addition to the transfer of advanced technologies, FDI may also lead to the “dumping” of outdated technologies. This seems to be more likely to occur with non-OECD suppliers or investors. Vietnamese officials, for instance, have raised concerns over the growing influx of outmoded or inferior technologies from China. On the other hand, such technologies also tend to be relatively cheap and therefore attractive to local producers who cannot afford the more sophisticated technologies available in industrialized countries. Also, local companies may be able to absorb and further develop less advanced technologies more easily; thus, such transfers may still help to spur technological progress in the long run.

Another influencing factor affecting the likelihood of spillovers is a country’s intellectual property regimes. The interaction between intellectual property rights (IPRs) and technology transfer is complex and evidence to date has not been able to conclusively answer whether strong IPRs help or hinder technology transfer through FDI in developing countries. In any case, the importance of IPRs in influencing a foreign investor’s decision to transfer technologies to local partners is likely to vary among industries. Thus, in sectors using standardized, labour-intensive technologies and products, IPRs are thought to play a limited role, while they are likely to become more relevant in complex but easily copied technologies. In general, however, it seems that the stronger the intellectual property rights, the higher the quality of technologies that is likely to be transferred. Also, strong IPR regimes may impact the channels for technology transfer, encouraging transfer of lower-technology processes through FDI and higher-tech processes through licensing, which in turn could affect the likelihood of spillovers.

In Southeast Asia, the link between IPRs and technology spillovers has not been studied in any detail. Looking at the World Economic Forum’s rankings of intellectual protection and access to new technologies through FDI in different Asian countries shows some interesting divergences (Table 3). Singapore, which has benefited most from FDI-induced technology transfer, also boasts one of the strongest IPR regimes in the world. However, other countries seem to have managed to attract a fair share of new technologies despite weak IPR regimes. Indonesia is particularly striking in this regard, with an IPR regime that ranks among the world’s bottom third while access to new technologies ranks in the top third. While it would be premature to draw conclusions on the causality between the two indicators, they point to interesting areas of further study.

71 Ibid, p. 27.
72 Oman (2000).
73 Rutherford et al. (2008).
74 Maskus (2000).
75 Maskus et al. (2004).
Table 3: IPRs and technology transfer through FDI in Southeast Asia

<table>
<thead>
<tr>
<th></th>
<th>Singapore</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Thailand</th>
<th>Vietnam</th>
<th>Indonesia</th>
<th>Cambodia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intellectual property protection</td>
<td>2</td>
<td>33</td>
<td>89</td>
<td>55</td>
<td>94</td>
<td>102</td>
<td>110</td>
</tr>
<tr>
<td>FDI and technology transfer</td>
<td>1</td>
<td>6</td>
<td>50</td>
<td>48</td>
<td>57</td>
<td>24</td>
<td>94</td>
</tr>
</tbody>
</table>

Source: WEF (2008)

### 4.1.4 Employment

Employment generation is another policy objective that motivates governments’ efforts to attract foreign investment. Employment statistics suggest that FDI has helped to create jobs in Southeast Asia, although to varying degrees across countries, sectors and the wider economy. In Malaysia, for instance, the share of FIE employment rose from 30 to 38 per cent between 1986 and 1999 along with the rise of FIEs’ share of total value-added of the manufacturing sector from 33 to 44 percent. As a result, Malaysia moved from a labour surplus to a labour shortage, which in turn contributed to considerable rises in wages throughout the economy. In Cambodia, direct employment in the largely foreign-owned garment industry increased from 19,000 in 1995 to 270,000 in 2005 while indirect employment has been estimated at around 242,000 jobs, including in services (transportation, trade, restaurants and other small services), non-garment manufacturing, agriculture and construction.

Special economic zones also proved effective in generating employment in some Southeast Asian countries (Table 1). The ILO estimates that by 2005/06, these zones were employing around 6 million workers in Indonesia, of which close to half a million people were in Malaysia and Thailand and just over 1 million people were in the Philippines and Vietnam. In Vietnam, the two operational export processing zones (out of 10 designated EPZs) was hosting around 75,000 workers, a little more than a quarter of total FIE employment in the country.

However, certain biases in investment policies have also meant that employment generation has not always been maximized. For instance, while the FIEs’ share in industrial employment in Vietnam increased considerably faster than that of non-FIEs (23 per cent compared with eight per cent between 2000 and 2003), employment growth did not keep pace with the growth of FIEs’ share in gross industrial output. The trend towards growth in capital intensive FIEs has been attributed to the investment policy’s emphasis on heavy industry in the 1990s and the domestic market bias in the trade policy regime. Similarly, due to the FIEs’ focus on mining, hydropower and forestry in the Lao PDR, employment generation has lagged considerably behind growth in capital inflows. Moreover, as discussed above, the emphasis on export-oriented industries—for instance in Thailand, Malaysia and Indonesia—and supply side constraints have limited the linkages and thereby employment opportunities for local suppliers.

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76 IISD (2004).
77 EIC (2007).
79 Singa Bpyenge (2007).
80 ADB (2006).
81 Ibid.
82 Ibid.
In addition to the quantity of employment, the quality also needs to be considered. Concerns have been raised that the desire to attract FDI and generate employment may lead governments to lower wages and labour standards (or become less strict in enforcing them), resulting in a “race to the bottom” as they compete for overseas investors.\footnote{Oman (2000).} Evidence regarding the impacts of FDI incentives on labour standards in Southeast Asia is limited. The ILO study noted that overall “labour relations and human resource development remain two of the most problematic aspects of zone functioning” and have undermined progress in wages, working conditions, productivity and job upgrading.\footnote{ILO (1998).} Conditions varied somewhat between the Southeast Asian case studies. Singapore has long applied the same laws to local and foreign firms and has involved trade unions in defining the investment strategy. The Philippines, after years of industrial conflict, only recently began to reform labour-management relations. Malaysia applies different rules to certain promoted activities, such as a five-year moratorium on collective bargaining in “pioneer companies,” and does not allow affiliations between trade unions in the electronics industry and national unions.

Some studies have also shown that foreign enterprises have paid higher wages than local ones, which at times has helped to raise wage levels overall. In Indonesia, for instance, higher wages paid by FIEs in the manufacturing industry were found to have also led to wage increases in local companies.\footnote{Lipsey and Sjöholm (2004).} Similarly, wages paid by FIEs in the mining and quarrying industry in Vietnam are generally higher than those paid by domestic firms (although the wage difference could also be due to the larger size of FIEs rather than the fact that they are foreign). While the gap has been closing in recent years, FIE wages are still almost four times higher than local wages.\footnote{Vu \textit{et al.} (2009).}

Also, fully understanding the employment gains from investment incentives will again require looking at the counterfactual—that is, would the FIEs have invested anyway? If yes, what employment opportunities could have been created with the financial resources lost through the provision of incentives, and what would have been the impacts on labour standards and wages? Research on these questions is still lacking.

### 4.1.5 Other social impacts

Much of the analysis of the social impact of investment incentives has focused on employment generation. A number of other positive and negative social impacts could be considered where incentives might have played a role by helping shape FDI decisions. For instance, in the Lao PDR and Cambodia, foreign investments in agricultural production and hydropower projects have provided new employment opportunities for rural workers and will improve electricity supply. However, these developments have also affected local livelihoods and increased social tensions as local communities are displaced from their land.\footnote{See, for example, ADB (2006), OHCHR (2007) \textit{Economic land concessions in Cambodia: A human rights perspective}, Office of the High Commissioner for Human Rights Cambodia: Phnom Penh.}
Moreover, FDI inflows have at times generated new opportunities for the employment of women. In the Philippines, almost three quarters of workers employed in the special economic zones are women, while female workers make up just over half of the total employment in Malaysia’s zones.88 In Cambodia, women, in particular from rural areas, constitute the vast majority of employees in the largely foreign-owned garment factories.89

On the negative side, investment incentives can offer opportunities for corruption. This is particularly true where incentives are provided on a discretionary basis, transparency is low and regulations and enforcement are weak. According to Transparency International’s Corruption Perception Index, corruption is rampant in several Southeast Asian countries, including Indonesia, Vietnam, the Philippines, Cambodia and the Lao PDR (Table 5); to what extent these levels are linked to the countries’ incentive schemes remains unclear. Corruption itself can become a disincentive to FDI, attract the “wrong” types of investors or deter FIEs from entering into joint ventures with local companies.90

4.1.6 Environmental impacts

The environmental impacts of investment incentives are seriously under-researched. Such impacts can occur where investment incentives increase the level of production or where the FDI projects itself negatively affects the environment.91 Large-scale foreign-funded hydropower, mining and agriculture projects currently underway in the Lao PDR and Cambodia are feared to have had devastating effects on the environment, owing to the absence of effective regulations that require and enforce the assessment and mitigation of environmental impacts. In Thailand, the FDI-driven rapid expansion of the electronic sector has raised serious environmental concerns arising from resource extraction, high energy consumption during production and hazardous electronic waste.92

Concerns have also been raised that FIEs may be attracted to an investment location to take advantage of lax environmental standards (or “pollution havens”) or that host governments may lower their environmental standards or fail to enforce them to attract foreign investors. Some studies have corroborated this fear while others have disputed it. Overall, however, there seems to be growing consensus that for most sectors, environmental standards do not play a significant role in influencing FDI decisions compared with other factors.93 Also, the cost of complying with environmental standards tends to be only a small part of overall production costs for most industries. Having said that, in some sectors—in particular energy intensive ones such as cement, iron and steel production—environmental standards may play a more important role.

Moreover, in some cases FIEs, in particular larger firms, have been found to apply higher standards than their domestic counterparts. In Vietnam, for instance, an enterprise survey found that the share of FIE carrying out pollution treatment activities, while not high overall, exceeded those of domestic enterprises (20 per cent compared with eight per cent).94 A review of the chemical industry in Indonesia’s Banten Province also found that foreign firms clearly outperformed domestic ones in terms of environmental performance.95

88 Singa Boyenge (2007).
89 EIC (2007).
90 Denolf (2008).
91 Thomas (2007).
93 The following discussion is based on Oman (2000) and Hing and Jalilian (2008).
94 Vu et al. (2009).
95 Adiningsih et al. (2009).
In addition to the actual impact of incentives and FDI competition on location decisions and environmental performance, Oman concludes that there is more evidence governments have tended to refrain from enforcing higher standards of environmental protection out of fear that their firms would suffer a competitive disadvantage, than there is evidence of firms actually relocating to take advantage of lower environmental standards in other countries.96

Indeed, despite the limited role of environmental standards in FDI decision, companies at times have threatened to relocate when negotiating with potential host governments. Other governments, however, have been found to increase their environmental standards to become a more attractive FDI destination. Further studies will be needed to better understand how these various dynamics have played out in Southeast Asia.

4.2 Importance of other factors

Investment incentives are only one of many factors that may influence an investor’s decision to invest in a certain location. Other determinants are related to the recipient country’s economic conditions, other policies and the strategies of the MNE (Table 4).

Table 4: Recipient country determinants of FDI

<table>
<thead>
<tr>
<th>Economic conditions</th>
<th>Markets</th>
<th>Size, income levels, urbanization, stability and growth prospects, access to regional markets, distribution and demand patterns</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Resources</td>
<td>Natural resources, location</td>
</tr>
<tr>
<td></td>
<td>Competitiveness</td>
<td>Labour availability, cost, skills trainability, managerial technical skills, access to inputs; physical infrastructure; supplier base; technology support</td>
</tr>
<tr>
<td>Recipient country policies</td>
<td>Macro policies</td>
<td>Management of crucial macro variables; ease of remittance, access to foreign exchange</td>
</tr>
<tr>
<td></td>
<td>Private sector</td>
<td>Promotion of private ownership; clear and stable policies; easy entry/exit policies; efficient financial markets, other support</td>
</tr>
<tr>
<td></td>
<td>Trade and industry</td>
<td>Trade strategy; regional integration and access to markets; ownership controls; competition policies; support for small and medium-sized enterprises (SMEs)</td>
</tr>
<tr>
<td></td>
<td>FDI policies</td>
<td>Ease of entry; ownership; incentives; access to inputs; transparent and stable policies</td>
</tr>
<tr>
<td>MNE strategies</td>
<td>Risk perception</td>
<td>Perception of country risk based on political factors, macromanagement, labour markets, policy stability</td>
</tr>
<tr>
<td></td>
<td>Location, sourcing, integration transfer</td>
<td>Company strategies on location, sourcing of products/inputs, integration of affiliates, strategic alliances, training, technology</td>
</tr>
</tbody>
</table>


There is general agreement in the literature that in the absence of a supportive investment environment, incentives are unlikely to attract significant FDI. Factors shaping the investment climate include political stability, social and physical infrastructure, cost variables (e.g., cost of labour and cost of capital), the macroeconomic environment, financial health and the level of institutional development.97 These conditions differ considerably between the Southeast Asian countries and a thorough analysis of these differences goes beyond the scope of this paper. Still, the countries’ performances in various global rankings provide a general indication of these differences (Table 5). At one end of the spectrum, Singapore scores high as a country that is globally competitive and easy to do business in. In contrast, the region’s least-developed countries (Cambodia and the Lao PDR) rank in or close to the bottom third on both counts.

97 See Banga (2003); ADB (2006).
It has been argued that countries seeking to attract FDI will be inclined also to work to improve the overall investment environment, given its relative importance vis-à-vis incentives. However, compared with the fundamental reforms that would be needed to improve the investment environment, incentives tend to be an easier and faster way for governments to show that they are actively working to attract overseas investment. Thus, the focus on investment incentives might at times end up detracting from the more fundamental changes that are necessary, not only to attract but also for a country to fully benefit from FDI.

Table 5: Selected global rankings of Southeast Asian countries

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>5</td>
<td>1</td>
<td>4</td>
<td>133,608</td>
</tr>
<tr>
<td>Malaysia</td>
<td>21</td>
<td>21</td>
<td>47</td>
<td>33,060</td>
</tr>
<tr>
<td>Thailand</td>
<td>34</td>
<td>14</td>
<td>80</td>
<td>49,476</td>
</tr>
<tr>
<td>Brunei</td>
<td>39</td>
<td>89</td>
<td>-</td>
<td>6,726</td>
</tr>
<tr>
<td>Indonesia</td>
<td>55</td>
<td>130</td>
<td>126</td>
<td>14,379</td>
</tr>
<tr>
<td>Vietnam</td>
<td>70</td>
<td>93</td>
<td>121</td>
<td>17,969</td>
</tr>
<tr>
<td>Philippines</td>
<td>71</td>
<td>141</td>
<td>141</td>
<td>12,859</td>
</tr>
<tr>
<td>Cambodia</td>
<td>109</td>
<td>136</td>
<td>166</td>
<td>2,390</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>Not available</td>
<td>166</td>
<td>151</td>
<td>658</td>
</tr>
</tbody>
</table>

Sources: WEF (2008); World Bank (2008); TI (2008); UNCTAD (2008)

Nevertheless, investment incentives can play an influential role where investors are choosing between a number of locations with comparable economic characteristics, regulatory frameworks, natural resources endowments, labour markets and education levels. What usually happens is that investors will draw up a list of suitable locations largely irrespective of the incentive schemes, and then decide on a specific location by comparing available incentives schemes.98 Also, even in cases where incentives do not play a role in an FDI decision, companies are only too happy to receive and even bargain for them.

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98 Oman (2000).
5 Incentives and Investment Competition

5.1 Investment competition in Southeast Asia

Incentive-based competition has become widespread around the world as national and local governments in both industrialized and increasingly developing countries seek to attract much-coveted FDI. In general, FDI competition is particularly prevalent among countries within the same geographical region that have comparable factor endowments. Southeast Asia is no exception to this global trend. Indeed, incentive-based FDI competition has been identified as one of the key driving forces behind the proliferation of increasingly generous investment incentives at the national, and in some cases sub-national levels. Several of the most important FDI sectors in Southeast Asia are among those where investment competition is most common, including automobiles, petrochemicals, electronics and information technology.

Globally, small or less developed countries and provinces are at the forefront of this trend in an effort to attract investment away from their larger or more advanced competitors. A similar pattern can also be observed in Southeast Asia where incentive-based competition was largely initiated by Singapore and followed by its neighbours. Cambodia, one of the poorest countries in Southeast Asia, is providing very generous incentives compared with other countries in the region, including a tax holiday of several years (depending on the investment project) followed by a concessionary corporate tax rate of about nine per cent (compared to a standard rate of 20 per cent). In Vietnam, investment competition among local governments was driven largely by the poorer provinces.

A number of factors have stimulated investment competition around the world, including in Southeast Asia. Economic integration through trade and investment liberalization, falling transportation and communication costs, and the emergence of multi-country production networks have made investment projects increasingly mobile and dispersed. The investors themselves have at times fuelled competition by trying to play governments off against each other. General Motors, for instance, was negotiating incentive packages with the governments of both the Philippines and Thailand to build a $500 million car plant in Asia in 1996. In the end, Thailand “won” the investment by offering to match the Philippines’ incentives while offering additional tax benefits and grants. A similar bidding war broke out between the Philippines and Vietnam in 2001 for a major investment by the US-based company Canon.

In the recipient country, political leaders are keen to be seen to advance economic development through attracting FDI. Incentives, in particular where they are targeted at high-profile projects, are easier to implement than more fundamental reforms of the investment environment. In addition, the emergence of site consultants, who are playing an increasingly important role in negotiating deals with recipient governments, has helped to achieve more favourable conditions for foreign investors, in particular where
the consultant’s fee is linked to the level of incentives negotiated.\textsuperscript{106} This is further exacerbated by widespread information asymmetry due to a lack of transparency of incentives programmes that hinders effective bargaining and increases the danger of graft, corruption and rent-seeking.\textsuperscript{107}

Moreover, the trend towards decentralization of government in many countries has stimulated incentive-based competition at the sub-national level, in particular when decentralization is not accompanied by financial support from the central government or the devolution of power to raise revenues. Overall, however, the linkages between decentralization, incentive-based competition and sustainable development remain poorly understood. Research in Vietnam showed that greater local control of FDI management and the pressure to achieve financial self-sustainability led to a proliferation of extra-legal incentives provided by local governments (also referred to as “fence-breaking,” i.e., incentives provided in violation of the law) to take advantage of the rapidly growing private sector, economic recovery and large FDI inflows in the early 2000s. Initially driven by the less developed provinces, fence-breaking quickly evolved into an “epidemic” and in just three years, half of the provinces had jumped on the bandwagon.\textsuperscript{108} In the end, the incentives failed to make up for shortcomings in the investment environment and FDI so many of the fence-breaking provinces in fact declined.

**Figure 8: Share of FDI inflows to Southeast Asia in selected recipient countries (1987–2007) (percent)**

![Graph showing FDI inflows to Southeast Asian countries](image)

Source: UNCTAD (2008)

No systematic studies have been carried out to look at the impacts of incentive-based competition on FDI diversion across the Southeast Asian region. The likelihood of such diversion would largely depend on overlaps in terms of FDI sectors, source countries, types of investors, investors’ motivations and the broader investment environment. At a general level, the FDI statistics and economic rankings cited above would suggest that incentives may play a role in diverting FDI between Singapore and Malaysia for high-tech industries as well as among Malaysia, Thailand, Indonesia, the Philippines and Vietnam.

\textsuperscript{106} Marcusen and Nesse (2007).
\textsuperscript{107} Oman (2000); Marcusen and Nesse (2007).
\textsuperscript{108} Vu et al. (2007).
for manufacturing components and medium-tech products for export. The regions’ least-developed countries (as well as Vietnam to a lesser extent) would likely compete for low-tech assembly industries and FDI in natural resource extraction and large-scale agricultural production.

Looking at changes in countries’ share of total FDI to the Southeast Asian region over the past 20 years, the largest changes in the relative share of investments that could potentially be attributed to incentive-based investment diversion have occurred in Singapore, Malaysia and Thailand, although the actual extent of such a diversion and the role of incentives is unclear (Figure 8).109

Similarly, evidence on the actual impacts of incentive-based competition on socio-economic and environmental progress is still inconclusive, both globally and for Southeast Asia. Some have argued that competition for mobile capital can be healthy, because it facilitates the efficient allocation of investment and encourages governments to improve the investment environment more generally, through the provision of infrastructure and the development of human capital, which will also benefit domestic businesses.110 More commonly, however, concerns have been raised that competition can lead to “bidding wars” that will leave all bidders no better or even worse off in the end. As Baldwin puts it:

Imagine that a crowd gathers to watch a parade. As the parade passes, people in the front stand on their toes to see better, thus forcing all those behind them to also stand on their toes. In the end, most see no better than before, but all have to stand on their toes.111

As a result, countries may end up shoudering the direct and indirect costs of providing incentives, thus forgoing financial resources that could have been spent more efficiently elsewhere. As discussed above, this is a particular concern in developing countries where government revenues are limited.

While the proliferation of incentives in Southeast Asia highlights the role that investment competition can play, it is still unclear whether this trend has had positive or negative impacts on the sustainable development of these countries, not least due to the difficulties in assessing the incremental costs and benefits of the incentives. An assessment of Malaysia and Singapore concluded that FDI competition did not seem to have led to an escalation of the cost of fiscal incentives relative to the size of FDI inflows,112 although understanding the true costs would require a more sophisticated analysis. In the end, as Charlton notes, “the welfare effects of investment competition depend on the context in which competition occurs and the nature of the incentive deal struck”.113

5.2 The “China effect”

Liberalization of Southeast Asian countries’ investment regimes has also been driven by concerns over FDI diversion to China.114 As Singapore’s then-Deputy Prime Minister (and now Prime Minister) Lee Hsien Loong warned in 2002, “Southeast Asian countries are under intense competitive pressure, as their former activities, especially labour-intensive manufacturing, migrate to China.”115 FDI inflows to

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109 As noted above, changes in Indonesia’s share of FDI inflows is likely due to political instability rather than investment diversion.
110 Charlton (2003); Oman (2000).
112 Oman (2000).
114 Thomsen (1999).
China (excluding Hong Kong) did increase markedly in the early 1990s, quickly surpassing investment flows to Southeast Asia (Figure 9). Similarly, China’s share in FDI inflows to Asia grew rapidly during that time, but has more or less stabilized since 1994 (Figure 10).

**Figure 9: Total FDI inflows to Southeast Asia and China (1980–2007) (billion $)**

![Chart showing total FDI inflows to Southeast Asia and China (1980–2007) (billion $).](source: UNCTAD (2008))

**Figure 10: Southeast Asia’s and China’s share of FDI inflows to Asia (1980–2007) (percent)**

![Chart showing Southeast Asia’s and China’s share of FDI inflows to Asia (1980–2007) (percent).](source: UNCTAD (2008))

Note: In this context, Asia refers to South, Southeast and East Asia. The dip in China’s share of FDI inflows to Asia in 2000 can largely be explained by exceptionally high FDI inflows to Hong Kong during that year.

Source: UNCTAD (2008)
Did this rapid FDI growth come at the expense of Southeast Asian countries? While China is likely to have diverted some FDI from Southeast Asia, several analyses have concluded that the “China effect” should not be overestimated. For a start, Chinese FDI data needs to be treated with some caution and may in fact exaggerate actual FDI inflows. It has been estimated that as much as 30–50 per cent of FDI inflows to China may be a result of “round-tripping” from the Chinese mainland via third markets (notably Hong Kong) back to the mainland in order to take advantage of investment benefits.\(^{116}\) Also, investment statistics are likely to be overblown as local governments strive to portray their regions as attractive destinations for FDI.\(^{117}\)

Addressing the question as to what extent FDI to China and Southeast Asia are substitutes, Thomsen points out that the relative importance of source countries for FDI to China and the Southeast Asian countries differ considerably.\(^{118}\) The largest share of FDI to China comes from Hong Kong, primarily from small- and medium-sized investors with limited financial and administrative capacities to invest further abroad. In contrast, MNEs dominate investments to the more advanced Southeast Asian nations, where competition would be expected to be more prevalent due to overlapping comparative strengths. Where China and these Southeast Asian countries do seem to compete, however, is for foreign investment seeking to benefit from their growing markets.

Several econometric studies have not found evidence of significant FDI diversion to China; rather, growing FDI inflows to China may have helped attract investment to the Southeast Asian region, at least at the aggregate level.\(^{119}\) This trend has been attributed to China’s role as “the last destination in a pan-Asian production chain” where capital goods and components are imported from various East and Southeast Asian countries for final assembly in China.\(^{120}\) This is particularly apparent in the electronics sector. Between 1990 and 2000, for instance, China has increased its imports of electronic products from East and Southeast Asia from 12 per cent to 62 percent.\(^{121}\) Moreover, one study found that other factors, such as lower corporate taxes and higher degrees of openness, have played a more important role in determining investment flows than the “China effect.”\(^{122}\)

At the same time, impacts appear to have differed among Southeast Asian countries. One study concluded that China has helped attract FDI to the Philippines, owing to the complementarities between the two economies while diverting FDI from Indonesia (due to competition for FDI in labour-intensive and low-tech products) and Malaysia (due to competition for FDI in the electronics industry and to a lesser extent the machinery and textile industries).\(^{123}\) In some other Southeast Asian countries, in particular the region’s least-developed countries, China is itself starting to emerge as an important investor, notably in the garment industry in Cambodia as well as agricultural production and mining in the Lao PDR and Cambodia.

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116 Wang et al. (2007).
118 Thomsen (1999).
119 Chantasasawat et al. (2004) covering Hong Kong, Taiwan, Republic of Korea, Singapore, Malaysia, Philippines, Indonesia and Thailand; and Wang et al. (2007) covering India, the Philippines, Indonesia, the Republic of Korea, Malaysia and Taiwan.
120 Enright (2000).
121 Humphrey and Schmitz (2007).
122 Chantasasawat et al. (2004).
123 Wang et al. (2007).
6 Investment Incentives in Bilateral and Regional Treaties

6.1 Bilateral trade and investment agreements

All Southeast countries have concluded bilateral investment treaties (BITs) or free trade agreements (FTAs) with other countries that include investment provisions (Figure 11 and Annex 3). The majority of these agreements have been signed by the more industrialized Southeast Asian countries. In addition to the negotiations with ASEAN as a whole, Japan, Korea, China and India have already entered into investment agreements (either BITs or FTAs with investment provisions) with the majority of (in the case of India and Japan) or all (in the case of China and Korea) Southeast Asian countries individually.

The agreements focus on investor protection by providing certain basic rights that aim to improve the security of, and thereby help attract, investments. While these agreements do not regulate the use of investment incentives specifically, they contain a number of provisions that are relevant in this context. For instance, some of the agreements allow for benefits (referred to as “advantages,” which are left undefined) offered to investors to be conditioned on certain performance requirements that a country may choose to apply to enhance the sustainable development benefits of the investment. For example, while the Japan-Philippines agreement prohibits the use of certain performance requirements, it provides for exceptions to some of these prohibitions in the case of investment incentives by allowing parties to make receipt of benefits conditions on compliance with requirements to hire a given level of

124 E.g., a commitment that the investors of the signatory parties will be treated no less favourably than national and other foreign investors (referred to as ‘national treatment’ and ‘most favoured nation treatment’); protection against expropriation and nationalization; a guarantee that funds related to the investment can be transferred freely into and out of the party’s territory; and a right for the investor to take investment disputes with a host state before an international arbitration tribunal without the involvement of the investor’s home state.
its nationals, transfer technology or locate the regional or global headquarters in the country that grants the benefits. The Singapore-US agreement allows the recipient country to attach (otherwise prohibited) requirements to benefits granted to investors related, for instance, to production location, training of employers and R&D.

More commonly however, the agreements explicitly prohibit the use of certain performance requirements across the board. Some agreements simply refer to the Annex of the WTO Agreement on Trade-related Investment Measures (TRIMs), which includes an illustrative list of prohibited TRIMs, such as local content requirements (i.e., the purchase of certain products from domestic sources) or quantitative restrictions on investors’ imports for local production. Others go beyond the WTO agreement to prohibit additional conditions, such as by prohibiting export performance requirements (i.e., that a certain amount or percentage of the output needs to be exported), restrictions on domestic sales or requirements to transfer technologies, production processes or other proprietary knowledge. Other examples include prohibitions of certain employment requirements related to the number of national employees or limitations on nationalities on certain high-level positions. Such TRIMs+ provisions have been criticized by some development economists for limiting a recipient country’s flexibility to use performance requirements to promote domestic development through linkages by a foreign investment into their wider economy.

A few agreements also include provisions to prevent parties from lowering environmental or labour standards to attract investment. Japan and Malaysia, for instance, agreed that neither country will “encourage investments by investors of the other Country by relaxing its environmental measures.” Similarly, Japan and Brunei Darussalam agreed that it was “inappropriate to encourage investments by investors of the other Party by relaxing its environmental measures” and that neither country will waive or derogate from environmental measures in order to attract or promote expansion of investments. A similar commitment is also included in the agreement between Japan and the Philippines. In addition, the countries agreed that it was equally inappropriate to “encourage investment by weakening or reducing the protections afforded in domestic labor laws,” adding that a Party may request consultations where it feels that the other Party has offered such an encouragement.

6.2 Regional investment rules for Southeast Asia

Investment competition tends to be particularly prevalent within regions. The European Union, for instance, where market integration is particularly far advanced, has adopted rules to regulate incentives at the regional level to prevent competition to turn into bidding wars. In Southeast Asia, the focus to date has been on attracting and facilitating investment flows. To this end, the ASEAN countries adopted a number of investment protection measures through the ASEAN Investment Guarantee Agreement (AIGA) in 1987 (revised in 1996).

125 Japan-Philippines Economic Partnership Agreement (Article 93).
126 United States-Singapore Free Trade Agreement (Article 15.8).
127 See e.g., the Japan-Philippines Economic Partnership Agreement (Article 93), Japan-Singapore New-Age Economic Partnership Agreement (Article 75), Free Trade Agreement between Republic of Korea and Republic of Singapore (Article 10.7), and United States-Singapore Free Trade Agreement (Article 15.8).
128 Japan-Philippines Economic Partnership Agreement (Article 93).
130 Japan-Malaysia Economic Partnership Agreement (Article 90).
131 Japan-Brunei Darussalam Economic Partnership Agreement, Article 72.
132 Japan-Philippines Economic Partnership Agreement, Articles 102 (environment) and 103 (labour).
similar to those commonly found in bilateral treaties, such as protection against expropriation or nationalization, guarantee of free transfers of capital and an investor-state dispute settlement mechanism.

Through the ASEAN Investment Area (AIA) adopted in 1998 (revised in 2001), the Southeast Asian countries aimed to further liberalize the regional investment environment in an effort to attract investment from within and outside the region, jointly promote ASEAN as an attractive investment area and facilitate the flow of investment and operation of investment projects in ASEAN. To this end, ASEAN countries agreed to open up all industries and extend national treatment to ASEAN investors by 2010 and to all investors by 2020. ASEAN members are allowed to temporarily exclude certain industries or investment measures from these obligations, as specified in self-designated Temporary Exclusion Lists which were to be progressively phased out (by 2003 for most ASEAN members and 2010 for Cambodia, Vietnam and the Lao PDR). In addition, industries and measures can be placed on a Sensitive List which will be periodically reviewed. The AIA does not contain provisions to regulate investment incentives.

Liberalization efforts were recently strengthened with the conclusion of the ASEAN Comprehensive Investment Agreement (ACIA) in August 2008, which merges and replaces the AIA and the AIGA to provide a uniform framework for the liberalization, facilitation, protection and promotion of investment in the region. The new agreement would speed up the liberalization of the investment environment, which is set to be completed by 2015 for all investors, and expand the scope of the agreement to also include portfolio investments. Among the newly introduced provisions, the ACIA would prohibit certain performance requirements and it mandates a joint assessment to consider additional requirements. The ACIA is set to be signed at the ASEAN Summit in December 2008.

As the ASEAN region becomes increasingly integrated through the progressive liberalization of investment and trade in goods and services, the incentive-based competition for FDI is likely to become more prevalent. However, the region has yet to move on adopting related provisions as other highly integrated regions have done. ASEAN could draw on the experiences in other trading blocs to identify measures that could feasibly be implemented in the region. As a first step, regional agreements can help to improve the transparency of incentive packages provided by the member states. In the European Union, for instance, all state subsidies must be reported to and approved by the European Commission (although distinguishing investment incentives from other types of subsidies remains a challenge).

In the longer term, region-wide regulations could help to ensure that investment incentives benefit the region as a whole with a minimum of trade distortion by regulating where, how and how many incentives are provided. In the EU, the amount of aid that can be provided in any region within the EU is capped at an amount related to the region’s level of economic development, with higher aid ceilings for less-developed regions. Structural Funds are available to co-finance investment incentives in the poorer regions. Moreover, in its decision on whether or not to approve certain state aid packages, the Commission also takes into account the competitive situation of the industry in question, and employment. While these provisions might not necessarily be directly transferable to the ASEAN context, they could provide some useful guidance and experiences for Southeast Asian policymakers.

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134 The text of the agreement had not been made public at the time of writing. The following summary draws on ASEAN (2008) Highlights of the ASEAN Comprehensive Investment Agreement, Presentation at the 40th ASEAN Economic Ministers (AEM) and Related Meetings, 25–29 August 2008, Singapore: Singapore.

7 Conclusions and Further Research

Based on a review of available evidence of the impacts of investment incentives on FDI decisions and sustainable development, it is safe to conclude that “incentives are effective in attracting some types of FDI some of the time in some places.”136 On the whole, some parts of Southeast Asia have been highly successful in promoting FDI as an important stimulus of economic growth, while others continue to lag behind. Whether the benefits have indeed outweighed the costs of providing incentives remains difficult to estimate. Also, even where FDI inflows have been substantial, the impacts on the wider economy in terms of technological spillovers, local industry development and employment generation have not always been as large as they could have been. At times, incentives may even attract FDI that ends up undermining sustainable development by contributing to social instability and environmental degradation.

The analysis above has highlighted the many variables that will play a role in determining the impacts of incentives. The source country, type of investor and nature of the investment will influence the importance of different incentives in shaping investment decisions. Social and environmental impacts, in turn, will be influenced by factors such as the local capacities to absorb technology and know-how, the composition of the labour market, the effectiveness of policies to address possible negative social and environmental impacts, and strong institutions to combat corruption. Moreover, in the absence of a supportive investment environment, incentives alone are unlikely to attract FDI and, importantly, promote sustainable economic, social and environmental progress. Understanding these dynamics is challenging, but crucial if governments are to move from reactive to proactive investment policy-making that can effectively use incentives to attract FDI and harness it for sustainable development.

The continued and accelerating economic integration of Southeast Asia through ASEAN, combined with the rapid growth of China, could place further pressure on governments to provide ever more generous incentives without a full understanding of their benefits. Southeast Asian governments clearly recognize the need for a common strategy to jointly promote ASEAN as an attractive region for investment. However, so far little has been done to regulate the use of incentives at the regional level and thereby ensure that incentive-induced FDI can promote the sustainable development of ASEAN as a whole without distorting competition and inducing costly bidding wars. Increasing transparency and coordination of incentive schemes will be a prerequisite in this endeavour.

This study has highlighted a number of information gaps in Southeast Asia where additional research could help inform investment policies. These include:

- An inventory of investment incentives provided by Southeast Asian countries categorized by the policy objective that they aim to achieve.
- A cost-benefit analysis of existing incentives with regard to government revenue.
- An assessment of the effectiveness of incentive schemes that are conditional on certain performance requirements.
- An evaluation of existing absorptive capacities to support knowledge and technology transfer as well as measures to address any gaps.

■ An analysis of the role of intellectual property rights in attracting FDI and facilitating technology transfer in Southeast Asia.

■ A systematic assessment of a variety of social and environmental impacts of investment incentives in Southeast Asia, including impacts on environmental and labour standards.

■ An evaluation of the impacts of incentive-based competition on FDI diversion inside and outside ASEAN.

■ A systematic analysis of the impacts of restrictions on performance requirements (and exceptions as they relate to investment incentives) in bilateral and regional trade and investment agreements involving Southeast Asian countries on FDI decisions and sustainable development.

■ Identification of options for regulating incentives at the ASEAN level based on a review of incentive regulations provided by other regional blocs.
Bibliography


Annex 1: FDI statistics for Southeast Asia

Table A.1: FDI in Southeast Asia by source country (1994–2005) (per cent)

<table>
<thead>
<tr>
<th>Source Country</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Indonesia</th>
<th>Vietnam</th>
<th>Cambodia</th>
<th>Lao PDR</th>
<th>Brunei</th>
<th>Myanmar</th>
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<td>78</td>
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<td>4</td>
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<td>1</td>
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<tr>
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<td>1</td>
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<td>New Zealand</td>
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<td>3</td>
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<tr>
<td>All others</td>
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<td>6</td>
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<td>4</td>
<td>10</td>
<td>30</td>
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</table>

Notes: Data do not include the source country distribution of reinvested earnings and intra-company loans of the Philippines and Singapore. The data reported by Cambodia between 1995 and 2000 were on an aggregate basis and therefore not included in this calculation.

EU-15 includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden and the United Kingdom.

A negative figure represents a net outflow of FDI.

Source: Compiled from ASEAN (2005)

Table A.2: FDI in Southeast Asia by sector (1999–2003) ($ million)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Indonesia</th>
<th>Vietnam</th>
<th>Lao PDR</th>
<th>Brunei</th>
<th>Myanmar</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, fisheries and forestry</td>
<td>-22</td>
<td>25</td>
<td>-67</td>
<td>-1</td>
<td>368</td>
<td>456</td>
<td>13</td>
<td>3</td>
<td>16</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>2</td>
<td>99</td>
<td>3,653</td>
<td>473</td>
<td>-730</td>
<td>1,713</td>
<td>38</td>
<td>5,246</td>
<td>714</td>
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<tr>
<td>Manufacturing</td>
<td>22,376</td>
<td>6,333</td>
<td>6,085</td>
<td>1,448</td>
<td>-8,213</td>
<td>2,705</td>
<td>41</td>
<td>101</td>
<td>122</td>
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<tr>
<td>Construction</td>
<td>606</td>
<td>-122</td>
<td>-6</td>
<td>58</td>
<td>-427</td>
<td>350</td>
<td>5</td>
<td>19</td>
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<tr>
<td>Trade/Commerce</td>
<td>9,380</td>
<td>3,098</td>
<td>155</td>
<td>40</td>
<td>-467</td>
<td>37</td>
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<tr>
<td>Financial intermediation and services</td>
<td>13,852</td>
<td>-457</td>
<td>762</td>
<td>503</td>
<td>2,012</td>
<td>103</td>
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<tr>
<td>Real estate</td>
<td>3,771</td>
<td>404</td>
<td>136</td>
<td>37</td>
<td>-716</td>
<td>12</td>
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<tr>
<td>Services</td>
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<td>1,106</td>
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<td>1,301</td>
<td>49</td>
<td>580</td>
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<tr>
<td>Others (not elsewhere classified)</td>
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<td>46</td>
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Notes: Data do not include the sector distribution of intra-company loans in Singapore and reinvested earnings and intra-company loans in the Philippines. The data reported by Cambodia were on an aggregate basis and therefore not included in this calculation.

Source: Compiled from ASEAN (2005)
## Annex 2: Selected investment incentives in Southeast Asia

<table>
<thead>
<tr>
<th></th>
<th>Singapore</th>
<th>Philippines</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Indonesia</th>
<th>Vietnam</th>
<th>Cambodia</th>
<th>Lao PDR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax holidays</td>
<td>5–10 years exemption from or reduction in corporate tax on profits for pioneer industries, tax reductions for plant expansion</td>
<td>6–8 years tax holidays for pioneer activities, and projects in less developed areas, 4–7 years tax exemptions for non-pioneer activities</td>
<td>5–10 years on 70–100% of statutory income for certain sectors, 10 years for investment in Multimedia Super Corridor</td>
<td>3–8 years income tax holidays depending on location (Zone 1, 2 or 3)</td>
<td>3–8 years for new enterprises in 22 sectors</td>
<td>2–8 years</td>
<td>tax holiday period determined according to the formula “trigger period + 3 years + priority years”*</td>
<td>3–7 years (depending on Zone)</td>
</tr>
<tr>
<td>Promoted activities</td>
<td>Pioneer industries (new manufacturing and service investments) declared by the Minister of Finance</td>
<td>Pioneer activities (new manufacturing industries; agricultural, forestry, and mining industries of national interest; industries using new technologies, projects in less developed areas; project expansion or modernization, export industries</td>
<td>Projects of national interest, in promoted areas, high-tech and R&amp;D</td>
<td>Automotive and electronics industries, export industries, activities located in remote areas, industrial zones processing of local agricultural raw materials</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduced corporate income tax (CIT) rates</td>
<td>Partial exemption on charges up to $300,000 (18% CIT standard)</td>
<td>Exemption for 4–6 years for companies located in the export processing zones (35% CIT standard)</td>
<td>3% for offshore companies in Labuan &amp; 10% for foreign fund management companies (28% CIT standard, to be reduced to 20% in 2009)</td>
<td>50% reduction for 5 years for enterprises in investment promotion zones (30% CIT standard)</td>
<td>Corporate income tax can be reduced by 30% of realized investment spread over a 6-year period (i.e., 5% per year) (28% CIT standard) to be reduced to 25% by 2010)</td>
<td>CIT exemptions (1–4 years) followed by 50% tax reductions (3–9 years) for certain sectors and locations</td>
<td>9% after end of holiday for favourised projects (20% CIT standard)</td>
<td>20% foreign investors (15% companies in lowlands; 10% companies in remote areas (32% CIT standard))</td>
</tr>
<tr>
<td>Import duty &amp; VAT exemptions</td>
<td>Customs duty exemption on machinery, raw materials and heavy oil for pioneer industries</td>
<td>Tax &amp; duty-free importation of capital equipment &amp; raw materials for zone enterprises; tax credit on raw materials &amp; supplies for BOI registered firms</td>
<td>Exemptions &amp; reduced import duty &amp; VAT rates on inputs in certain sectors especially exporters</td>
<td>Exemptions &amp; reduced import duty &amp; VAT rates on inputs in certain sectors especially exporters</td>
<td>Exemptions &amp; reduced import duty &amp; VAT rates on inputs in certain sectors especially exporters</td>
<td>Duty-free importation of capital equipment and spare parts for initial installation of promoted investment</td>
<td>Reduced import duties on inputs: 0% for exporters and 1% for other foreign firms</td>
<td></td>
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<tr>
<td>Investment allowances &amp; credits</td>
<td>Exemption of taxable income equal to a specified proportion of new fixed investment in certain industries</td>
<td>Tax credits for purchases of domestic breeding stocks &amp; genetic material as well as for incremental revenue</td>
<td>Investment allowance of 3–40% of qualifying capital expenditure (start-up and annually)</td>
<td>Allowance of 25% for investment in infrastructure</td>
<td>Reduction of taxable income by up to 30% of investment in priority sectors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>Accelerated depreciation for certain plants, machinery and equipment</td>
<td>Immediate expensing of major infrastructure investments by export enterprises in less developed areas</td>
<td>Accelerated depreciation of computer technology &amp; environmental protection investments</td>
<td>Doubling of depreciation rates in favoured zones and sectors</td>
<td>Doubling of depreciation rates for accelerating technological renovation of machines and equipment</td>
<td>Generous accelerated depreciation for all qualified investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Limits on foreign equity participation</td>
<td>Almost no restrictions on foreign ownership (with exceptions for national security purposes and in certain industries)</td>
<td>100% foreign ownership in pioneer areas, industries in EPZs, and industries exporting at least 70% of production</td>
<td>Up to 100% foreign ownership depending on 1% of production exported, location, size of investment and amount of value added domestically</td>
<td>100% foreign ownership in promoted sectors</td>
<td>Up to 100% in most sectors (some contingent on certain % of production destined for export)</td>
<td>100% foreign ownership allowed in export-oriented and priority projects</td>
<td>100% foreign ownership allowed in all sectors/industries</td>
<td>At least 30% foreign capital is required in joint ventures. 100% foreign ownership is allowed in all sectors except mining and electricity</td>
</tr>
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</table>

*Trigger period: the first year of profit or 3 years after the first revenue is made, whichever is sooner. Priority period: to be determined by the Council for the Development of Cambodia according to national developmental priorities.

### Annex 3: Bilateral and regional investment agreements by ASEAN countries

<table>
<thead>
<tr>
<th>OECD countries</th>
<th>ASEAN countries</th>
<th>Other countries</th>
<th>FTAs with investment provisions (in force or pending ratification)</th>
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<td></td>
<td><strong>ASEAN, China, India, Japan, Korea (Republic of)</strong></td>
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<td><strong>Singapore</strong></td>
<td>Belgium &amp; Luxembourg, Czech Republic, France, Germany, Hungary, Japan, The Netherlands, Poland, Switzerland, Turkey, United Kingdom</td>
<td>Cambodia, Indonesia, the Lao PDR, Vietnam</td>
<td>Belarus, Bulgaria, China, Egypt, Jordan, Latvia, Mauritius, Mongolia, Oman, Pakistan, Peru, Saudi Arabia, Slovakia, Slovenia, Sri Lanka, Taiwan, Zimbabwe</td>
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<td><strong>Malaysia</strong></td>
<td>Austria, Belgium &amp; Luxembourg, Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Korea (Republic of), Netherlands, Norway, Poland, Spain, Sweden, Switzerland, Turkey, United Kingdom</td>
<td>Cambodia, Indonesia, the Lao PDR, Vietnam</td>
<td>Albania, Algeria, Argentina, Bahrain, Bangladesh, Bosnia and Herzegovina, Botswana, Burkina Faso, Chile, China, Croatia, Cuba, Djibouti, Egypt, Ethiopia, Ghana, Guinea, India, Iran (Islamic Republic of), Jordan, Kazakhstan, Korea, DPR, Kuwait, Kyrgyzstan, Lebanon, Macedonia FYR, Malawi, Mongolia, Morocco, Namibia, Pakistan, Papua New Guinea, Peru, Romania, Saudi Arabia, Senegal, Sri Lanka, Sudan, Taiwan, Turkmenistan, United Arab Emirates, Uruguay, Yemen, Zimbabwe</td>
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<tr>
<td><strong>Thailand</strong></td>
<td>Belgium &amp; Luxembourg, Bulgaria, Canada, Czech Republic, Finland, Germany, Hungary, Netherlands, Poland, Korea (Republic of), Sweden, Switzerland, Turkey, United Kingdom</td>
<td>Cambodia, Indonesia, the Lao PDR, Philippines, Vietnam</td>
<td>Argentina, Bahrain, Bangladesh, China, Croatia, Egypt, Hong Kong, India, Israel, Jordan, Korea, DPR, Peru, Romania, Russian Federation, Slovenia, Sri Lanka, Taiwan, Tajikistan</td>
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<tr>
<td><strong>Indonesia</strong></td>
<td>Australia, Belgium &amp; Luxembourg, Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Korea (Republic of), Netherlands, Norway, Poland, Spain, Sweden, Switzerland, Turkey, United Kingdom</td>
<td>Cambodia, Indonesia, the Lao PDR, Malaysia, Philippines, Singapore, Thailand, Vietnam</td>
<td>Algeria, Argentina, Bangladesh, Bulgaria, Chile, China, Croatia, Cuba, Egypt, India, Indonesia, Jamaica, Jordan, Korea, DPR, Kyrgyzstan, Mauritius, Mongolia, Morocco, Mozambique, Pakistan, Poland, Qatar, Romania, Slovakia, Sri Lanka, Sudan, Suriname, Syrian Arab Republic, Tajikistan, Tunisia, Turkmenistan, Ukraine, Uzbekistan, Venezuela, Yemen, Zimbabwe</td>
</tr>
<tr>
<td><strong>Philippines</strong></td>
<td>Australia, Austria, Belgium &amp; Luxembourg, Canada, Czech Republic, Denmark, Finland, France, Germany, Italy, Korea (Republic of), Netherlands, Portugal, Spain, Sweden, Switzerland, Sweden, Turkey, United Kingdom</td>
<td>Cambodia, Indonesia, Myanmar, Thailand, Vietnam</td>
<td>Argentina, Bangladesh, China, Croatia, Cuba, Egypt, India, Indonesia, Jamaica, Jordan, Korea, DPR, Kyrgyzstan, Mauritius, Mongolia, Morocco, Mozambique, Pakistan, Poland, Qatar, Romania, Slovakia, Sri Lanka, Sudan, Suriname, Syrian Arab Republic, Tajikistan, Tunisia, Turkmenistan, Ukraine, Uzbekistan, Venezuela, Yemen, Zimbabwe</td>
</tr>
<tr>
<td><strong>Vietnam</strong></td>
<td>Australia, Austria, Belgium &amp; Luxembourg, Czech Republic, Denmark, Finland, France, Germany, Hungary, Iceland, Italy, Japan, Korea (Republic of), Netherlands, Poland, Spain, Sweden, Switzerland, United Kingdom</td>
<td>Cambodia, Indonesia, the Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand</td>
<td>Algeria, Argentina, Armenia, Bangladesh, Belarus, Bulgaria, Chile, China, Cuba, Egypt, India, Korea, DPR, Latvia, Lithuania, Mongolia, Namibia, Romania, Russian Federation, Taiwan, Tajikistan, Ukraine, Uzbekistan</td>
</tr>
<tr>
<td><strong>Cambodia</strong></td>
<td>Austria, France, Germany, Japan, Korea (Republic of), Netherlands, United States of America, Switzerland</td>
<td>Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam</td>
<td>China, Croatia, Cuba, Pakistan</td>
</tr>
<tr>
<td><strong>Lao PDR</strong></td>
<td>Austria, Denmark, France, Germany, Japan, Korea (Republic of), Netherlands, Switzerland, United Kingdom</td>
<td>Indonesia, Malaysia, Myanmar, Singapore, Thailand, Vietnam</td>
<td>China, Cuba, India, Mongolia, Pakistan, Russian Federation</td>
</tr>
</tbody>
</table>

* As of 1 June 2008. Where the country is written in italics, the agreement has not yet entered into force.

** Signed, ratification status not known.