Effective Use of Performance Requirements and Investment Incentive

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Abstract

This paper reviewed a theoretical background rationalizing performance requirements, particularly employment and training requirements which are used by host countries in conjunction with investment incentives as a FDI policy means to achieve economic objectives. And it discusses main observations from the study and proposes some policy alternatives helpful for the government of Mongolia to benefit from FDI through performance requirements in conjunction with investment incentives.

Key words: performance requirements, investment incentives, employment and training requirements, economic development objectives

I. Introduction

Foreign direct investment (FDI) can play a significant role in the development process of host economies. In addition to providing capital inflows, FDI can be a vehicle for increasing employment and upgrading the skills of the local work force, and improving the economic performance of countries. However, neither inflows of FDI nor the benefits from such inflows are automatic.

Thus, most countries are attracting FDI with the increased attention given to policies that can enhance the development benefits of such investment. Among a number of policy alternations helpful for governments to optimize the impact of FDI, performance requirements are being still considered with importance and of a great interest. Performance requirements may be described as the conditions given to foreign investors requiring them to meet certain specified goals with respect to their operations in the host country. They are and have been used together with other policy instruments, such as investment incentives, to enhance various development objectives (UNCTAD, 2003).

Mongolia has been paying a great deal of attention to the issue of attracting FDI and using it effectively in the achievement of the economic development ob

jectives. However, it seems to have a passive attitude towards imposing performance requirements on foreign investors with some relevance to the investment incentives. The purpose of this paper is to examine conjunction between performance requirements and investment incentives, and how host countries use them to achieve the economic objectives. Also, it will discuss some policy alternatives helpful for the government of Mongolia to benefit from FDI through performance requirements together with investment incentives.

The paper is organized as follows. Section 2 reviews the theoretical background rationalizing performance requirements and investment incentives as a means to achieve economic objectives. Section 3 reviews a present situation of performance requirements, particularly employment and training requirements together with investment incentives of Mongolia. Section 4 discusses the main observations from the study and proposes some policy alternatives on using performance requirements in conjunction with investment incentives for Mongolia. Finally, there is a concluding section.

II. Theoretical background

1. Relevance between performance requirements and investment incentives

In UNCTAD publication, performance requirements are described as one kind of so-called "host country operational measures" with the main other measures being various restrictions (UNCTAD, 2001). There are 14 performance requirements in total and they can be divided into three categories (see Table 1): the first category consists of those that are explicitly prohibited by the WTO Agreement on Trade-Related Investment Measures (TRIMs) because they are inconsistent with Articles III and XI of GATT/1994; the second includes requirements that are explicitly prohibited, conditioned or discouraged by interregional, regional or bilateral (but not by multilateral) agreements; and the third category covers requirements that are not subject to control through any international investment agreement (IIA) (UNCTAD, 2003).

Table 1. Category of performance requirements

Category	Performance requirement
Prohibited by the	Local content requirements
TRIMs Agreement	Trade-balancing requirements Foreign exchange restrictions related to the foreign-exchange inflows attributable to an enterprise Export controls

Prohibited, conditioned or discouraged by IIAs at bilateral or regional levels	Requirements to establish a joint venture with domestic participation Requirements for a minimum level of domestic equity participation Requirements to locate headquarters for a specific region Employment requirements Export requirements Restrictions on sales of goods or services in the territory where they are produced or provided Requirements to supply goods produced or services provided to a specific region exclusively from a given territory Requirements to act as the sole supplier of goods produced or services provided Requirements to transfer technology, production processes or other proprietary knowledge Research and development requirements
Not restricted	All other performance requirements

Source: Adapted from United Nations Conference on Trade and Development (UNCTAD) (2001). Host Country Operational Measures. UNCTAD Series on issues in international investment agreements, (Geneva and New York: United Nations), United Nations publication, Sales No. E.01.II.D.19, p. 3.

Performance requirements are used to tilt the distribution of gains from investments in favor of the host country (UNCTAD, 2003). Governments tend to impose performance requirements to achieve macro- or microeconomic development goals or to affect the distribution of benefits among regions or the population at large. Specific objectives for imposing performance requirements include strengthening the industrial base, generation of employment opportunities, linkage promotion, export generation, trade balancing, regional development promotion, technology transfer, etc. (UNCTAD, 2003).

Performance requirements may cover all aspects of investment and are often used in conjunction with investment incentives on the same economic rationale. And it would be misleading to consider investment incentives without also discussing performance requirements because of the linkages between the two (Brewer and Young, 1997).

Basically, investment incentives may be defined as any measurable advantages accorded to specific enterprises or categories of enterprises by a government in

order to encourage them to behave in a certain manner. They include measures specifically designed either to increase the rate of return of a particular FDI undertaking, or to reduce its costs or risks (OECD, 2003; UNCTAD, 2004). And they consist of fiscal incentives such as tax holidays and lower taxes for foreign investors, financial incentives such as grants, preferential loans to multinational corporations and government insurance at preferential rates, as well as other measures like market preferences, stabilization clauses guaranteeing that existing regulations, infrastructure, and subsidized services (Brewer and Young, 1997; OECD, 2003; UNCTAD, 2004). Most countries, irrespective of their stage of development, employ a variety of incentives to realize their investment objectives. According to UNCTAD (2000), developed countries more frequently employ financial incentives such as grants, subsidized loans or loan guarantees. It is commonly recognized that financial incentives are a direct drain on the government budget, and so then, they are not offered by developing countries. Investment incentives can be designed to channel investment for development of a particular area, or promote sectors of industry (e.g., mining and industrial parks) or activities considered crucial for development (e.g., export promotion, employment, skills training, and domestic value added). Therefore they must be based on rules, not discretion, thus making them more broad and general, usually a part of a more comprehensive economic development strategy (Palmade and Anayiotas, 2004).

Host countries' support for FDI incentives provides evidence that investment incentives are effective in attracting FDI on the assumption that FDI assists in achieving the economic goals (Ruane, 2008). According to Blomstrom and Kokko (2008), investment incentives have become increasingly important for national policymakers who are trying to promote local production, employment, and welfare. UNCTAD (2000) noted that the offer of incentives can be justified on the grounds of the positive externalities or spillovers from FDI. To prove it, in recent years an increasing number of host governments provide various forms of investment incentives to encourage foreign investors (UNCTAD, 2000).

The linkages between performance requirements and investment incentives derive from the fact that the former may be negotiated as a quid pro quo for incentives (Brewer and Young, 1997). A "carrot and stick" approach is frequently observed here and it has long been a feature of the regulatory framework governing FDI in host countries (McCulloch 1991).

Studies on the effectiveness of performance requirements show the mixed results. For instance, some studies show that effective local content requirements will induce foreign firms to increase their own domestic production of the component input and induce capital flows thus furthering the process of industrialization of host country (Richardson, 1993). However, other studies suggest that local content requirements will retard economic development:

Local content requirements, for example, illustrate a distinction between short-term advantage and long-term disadvantage. Local content requirements may force a foreign affiliated producer to use locally produced parts. Although this requirement results in immediate sales for the domestic parts industry, it also means that this industry is shielded from the salutary effects of competition. In the end, this industry will fail to improve its international competitiveness. Moreover, the industry using these parts is unable to procure high-quality, low-priced parts and components from other countries, and will be less able to produce internationally competitive finished products. The domestic industry can hope to achieve, at best, import substitution, but the likelihood of further development is poor (METI, 2010).

Performance requirements have been extensively applied by a large number of countries at different stages of development. And the incidence of performance requirements have varied across countries, depending upon their development strategy, endowments of natural and other resources, and market size, among other factors. For instance, Korea had applied the local content requirements and export performance requirements to a wide range of industries till abolish them in the mid-1980s.

2. Employment and training requirements

In this section, the focus of the analysis is on employment and training requirements that relate to the second category. This measure is prohibited at the multilateral level but is forbidden in various bilateral or regional contexts (UNCTAD, 2001; UNCTAD, 2003).

Employment and training requirements may be imposed for several reasons. The purpose can be to induce foreign investors to engage more actively in training and human resource development activities and to encourage the expansion of certain skill-intensive functions. Employment and training requirements may sometimes take the voluntary form. The extent to which voluntary requirements in this area have a positive impact on the stated development objectives partly depends on the value of the efforts accruing to the foreign investors. The more interested the companies are in enhancing the skills of their own workforce (or that of suppliers and distributors), the more likely it is that they will participate in related government-sponsored activities. The interest on the part of investors is also affected by the way employment or training requirements/incentives are implemented (UNCTAD, 2003).

Employment or training requirements have been applied in various forms (UNCTAD, 2001; UNCTAD, 2003). For instance:

- Employment requirements were introduced in Malaysia in 1972 with the introduction of the Labor Utilization Relief incentive. It provided increas-

ingly generous tax exemptions for pioneer status industries the greater the number of full-time employees. Foreign invested firms with 51 to 100 employees were eligible for 2 years of income tax exemption; those with 101 to 200 employees were eligible for 3 years; those with 201 to 350 for 4 years, while those with 351 employees or more, could enjoy up to 5 years of income tax relief. The employment requirements continued into the 1990s.

- Double deductions for training expenses were given for approved manpower training in the manufacturing sector of Malaysia from 1991. The purpose of this scheme was to encourage companies to participate in approved programs designed to develop workers' skills needed to raise productivity.
- In Singapore, the Skills Development Fund gives financial assistance to companies for training their workers; and tax incentives are offered in Korea.
- In 1993, Malaysia introduced the Human Resources Development Fund with the purpose to encourage direct private-sector participation in skills development programs. According to this scheme, manufacturing firms employing 50 or more Malaysian workers were required to contribute the equivalent of one per cent of their monthly wage bill to the Fund. In return, companies could then apply for reimbursement of between 75 and 95 per cent of allowable cost incurred for training in Malaysia and up to 50 per cent of the cost for training abroad, related to the amount they have contributed to the Fund.
- In 1995, another 100 per cent investment tax allowance for 10 years was introduced for training expenses.

Double deductions were also automatically given if training was received from approved institutions.

- By the year 2000, additional incentives were developed, such as special capital allowances for computers and single deductions for pre-operation training expenses.
- The promotion of local employment can be achieved either by imposing a quota or other form of restriction (visas, work permits, etc.) on the employment of foreign personnel, or by establishing a local hiring target that foreign affiliates have to meet (UNCTAD, 2001).

III. Performance requirements and investment incentives in Mongolia

Mongolia does not impose any performance requirements on foreign investors. As a member of the WTO, Mongolia is bound by the TRIMs, under which it is prohibited from imposing four specific performance requirements on investors

(a) the use of products of domestic origin (local content requirement); (b) conditioning imports by the investor on the amount of local production that it exports (trade-balancing requirement); (c) restricting the importation of products used in its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise (foreign exchange restrictions); and (d) restricting the exportation by an enterprise of products, whether in terms of particular products, in terms of volume or value of its local production (export restrictions).

Furthermore, it seems to have abolished all performance requirements, including those permitted by the WTO, such as export requirements, technology transfer requirements and employment requirements. Some studies describe such a situation:

Generally, foreign investors need not use local goods, services, or equity, or engage in substitution of imports. Neither foreign nor domestic businesses need purchase from local sources or export a certain percentage of output, or have access to foreign exchange in relation to their exports (US Embassy, 2011).

There is no requirement for foreign investors to employ the local workforce. Certain tenders and projects on strategic deposits[1] may require agreeing to specific levels of local employment as a condition of the tender or project. For instance, in October 2009, the government of Mongolia, Ivanhoe Mines of Canada, and Rio Tinto jointly negotiated investment and share-holders agreements respectively for the Oyu Tolgoi (OT) copper- gold deposit located in Mongolia's South Gobi desert. The OT agreement vests the government of Mongolia with 34% ownership of the project and provides guarantees for local employment. With construction well underway and over 6,000 workers employed by OT project.

As for the investment incentives, there are no specific incentives for employment and training in the mining as well as other sectors. Investment incentives, in response to resistance that tax incentives discriminate against local enterprises in favor of foreign-invested companies, the parliament of Mongolia amended the laws to eliminate the tax incentives for foreign companies starting from mid-2006. But it offers incentives only for relatively larger projects by signing Stability

Agreement. Till today it has signed the stability agreement with seven investing firms in the mining sector, and it has been providing them with the stabilizations of payable taxes. On this stability agreement, totally eight taxes including corporate income tax, value added tax, customs tariff, excise tax, fees on minerals, real estate tax, and windfall income tax, were stabilized at the determined rates for 30 years.

1 In accordance with Mineral Law of Mongolia, "mineral deposit of strategic importance" means a deposit with size that may have a potential impact on national security, economic and social development of the country at the national and regional levels or that is producing or has a potential of producing more than five percent of total Gross Domestic Product in a given year. There are 15 strategic deposits.

IV. Policy implications for Mongolia

The government of Mongolia has defined its five year Action Plan for the period of 2008-2012 and on this Action Plan the medium term economic development goals have been identified as an reduction of poverty and decrease of unemployment (Ministry of Finance of Mongolia, 2008).

FDI policy measures supportive for these goals may include, among others, investment performance requirements and incentives through which the subject foreign companies may find these requirements less burdensome to fulfill.

The mining sector of Mongolia is the sector which occupies the largest share of the total FDI inflows into the country, and more and more foreign investors are being interested in this sector. Seeing the trends of this sector, Mongolia could impose employment requirements on foreign investors and offer incentives which will reduce the burden of the subject companies. Some studies by the international organization and the Mongolian government organizations do propose the similar suggestions:

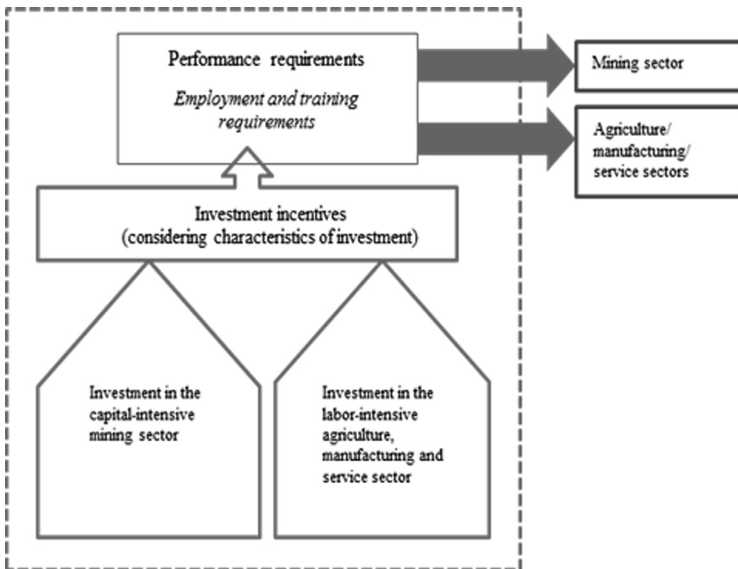
> While Mongolia does not impose many performance requirements on investors, it did not accept any TRIMs-plus commitments in its terms of accession to the WTO and is free to impose a number of performance requirements on foreign investors to attain human development goals, including employment and transfer of technology requirements (MOFAT and UNDP, 2009).
>
> It appears, however, that in the Bilateral Investment Treaty with the United States, Mongolia agreed to abolish all performance requirements, including those in the mining sector and those imposed for human development-oriented objectives. This could be corrected in future negotiations (MOFAT and UNDP, 2009).

However, the capital-intensive mining sector may be less likely to have a broad impact on poverty and unemployment reduction than labor-intensive service, manufacturing and agriculture sectors. Poverty in Mongolia owes a lot to the failure of the growth process to generate remunerative employment in sufficient number and quality. Mongolia has a 64.2 percent labor-force participation rate (MOFAT and UNDP, 2009). The agricultural sector, wholesale and retail trading, public administration and education generated more than half of the whole employment in 2007.

Thus, it is recommendable to impose performance requirements on foreign-invested companies in the labor-intensive agriculture, manufacturing, and service sectors, and to provide incentives with what the subject foreign companies could perform the requirements effectively. There are two options. One is benchmarking successful practices of Malaysia, Korea and Singapore. Fiscal incentives

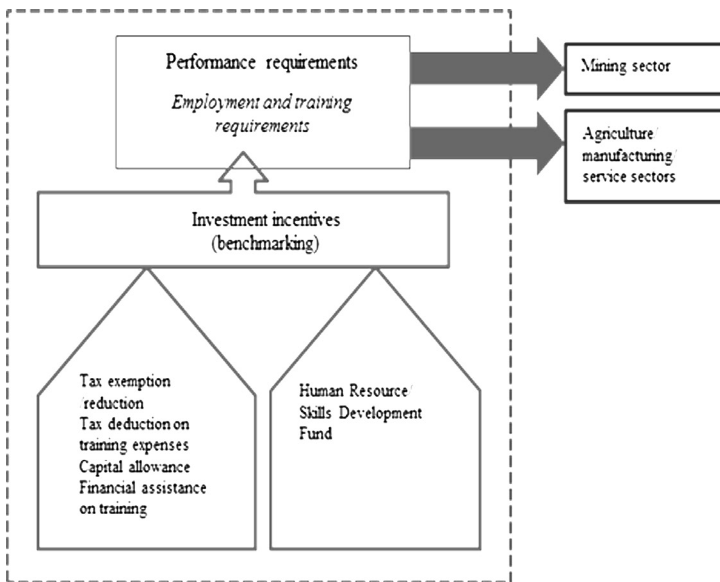
(e.g., deductions from taxable earnings based on the number of employees or on other labor-related expenditures, capital allowance, exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process, etc.), financial assistance on training, and training promotion measures (e.g., establishment of a skills/human resource development fund and the similar schemes) could be mentioned here (See Figure 1).

Figure 1. Option one: Using performance requirements and investment incentives effectively



Another one is designing incentives considered characteristics of the agriculture, manufacturing, and service sector investments. When assess the appropriateness of incentives, the position of investors and policy-makers need to be taken into account (OECD, 2003). Multinational corporations respond differently to different types of incentives depending on their motivation of the investment (Gregerly, 2003). As investment incentives by its nature reduce cost, and maximize the return, and multinational corporations leading by any investment motives are assumed to favor any investment incentives. Most important, perhaps, is that FDI motives per se regard different factors as important; consequently, the preferable investment incentives may be different (Dunning, 2003). However, host governments, as they have the limited budget, particular legal structure and definite policy objectives, are assumed to have a different position on offering different types of investment incentives (OECD, 2003; Kransdorff, 2010; Brooks et al). (See Figure 2)

Figure 2. Option two: Using performance requirements and investment incentives effectively



V. Conclusion

Considering the passive attitude towards using performance requirements as a FDI policy attributable to achieving the economic goals of the Mongolian government, the paper aimed at proposing some alternative policy alternatives recommendable for the government of Mongolia to benefit from FDI through performance requirements in conjunction with investment incentives. In order to do it, the paper examined relevance between performance requirements, particularly employment and training requirements and investment incentives as a FDI policy means to achieve economic objectives at first, and then reviewed the current situation of performance requirements in conjunction with investment incentives of Mongolia.

As a result of the study, the paper presents the following findings. First, Mongolia does not impose many performance requirements on foreign investors. There is no requirement for foreign investors to employ and train the local workforce. Certain tenders and projects on strategic deposits may require agreeing to specific levels of local employment as a condition of the tender or project. As a member of the WTO, Mongolia is bound by the TRIMs, under which it is prohibited from imposing four specific performance requirements on investors. Furthermore, it seems to have abolished all performance requirements, including those permitted by the WTO, such as export requirements, technology transfer requirements and

employment requirements. Second, as for investment incentives, there are no specific incentives for employment and training. It offers incentives only for relatively larger investment projects by signing Stability Agreement in the mining sector.

Accordingly, some policy alternatives would be proposed to use performance requirements, i.e. employment and training requirements in conjunction with investment incentives. First, the government of Mongolia should plan performance requirements with incentives for either capital-intensive (i.e. mining sector) and labor-intensive (i.e. agriculture, manufacturing, and service sectors) sectors as the capital-intensive mining sector may be less likely to have a broad impact on poverty and unemployment reduction than labor-intensive agriculture, manufacturing, and service sectors. Second, it should develop and design a package of investment incentives through which the subject foreign companies may find these requirements less burdensome to perform. There are two options: benchmarking successful practices of Malaysia, Korea and Singapore; and designing incentives considered characteristics of the mining as well as agriculture, manufacturing, and service sector investments.

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