c/O (letter only)

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Secretary of State for Trade and Industry

10 August 1984

Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign and
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WBPn

D Geoffrey.

DIRECT PRIVATE INVESTMENT OVERSEAS

will request if required

Following Ministerial corrspondence at the end of last year, resting with my letter to you of 14 December, it was agreed that a group of officials under DTI Chairmanship should examine our policy towards British private direct investment overseas. The group has now completed its review and I attach a copy of its report.

2 I believe that, as the report argues, there is a useful role for the Government in drawing attention to the benefits that can flow from private overseas investment. There are considerable advantages for less developed countries in attracting such investment from more developed countries; this is normally seen in terms of investment in third world countries, but I think that we should not lose sight of the benefits which we derive from Japanese and US investment here. Outward investment by UK firms can bring profits for them, and also opportunities for wider exports from the UK.

3 While I therefore agree with many of the report's conclusions and recommendations, I do have serious doubts about the idea of new Government expenditure to subsidise firms who are interested in investing overseas. I accept that ODA, in putting forward their proposals for such a scheme (paragraph 20(i) of the report and Annex 5) see certain benefits to developing countries in proposing such subsidies, but in the context of our overall commitment to cut public expenditure, I believe that we should not take on these extra commitments. On a much less important point, while Departments will need to deal comprehensively with enquiries about the ways in which we can assist overseas investment, I do not think that there would be enough to justify a separate BOTB leaflet as recommended in the report (paragraph 20(iii)(f)).

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4 Subject to these points, I find the recommendations useful, though you will see that they are hardly far-reaching. On the other hand, any increase in Government encouragement for overseas investment will be politically controversial, however ill-founded the criticisms.

5 If colleagues are content with the approach set out in this letter, it may be possible to come to a view on the report in correspondence without a meeting, though I would of course be happy to discuss it if that is what other would prefer.

6 The report also recommends that officials should report back on the implementation of the measures agreed in due course. I agree, and think that a period of 12 months from implementation should allow time to judge if they are having any effect.

7 I am copying this letter and the report to the Prime Minister, the Lord President, the Chancellor of the Exchequer, the Secretary of State for Employment and Sir Robert Armstrong.

Yours
Norman

NORMAN TEBBIT

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REPORT OF WORKING GROUP ON DIRECT INVESTMENT OVERSEAS

SUMMARY AND CONCLUSIONS

1 Officials have examined Government policy towards British private direct investment overseas, primarily by means of a review of investment experience and conditions in selected key countries. The UK has traditionally undertaken more overseas investment (about four fifths of it in other OECD countries) than other developed countries (except the USA) but in recent years others have been catching up. Officials looked particularly at the impact of direct investment overseas on export performance, aid policy and developing country indebtedness.

2 Exchange controls were removed in 1979 and the Government has taken the view that decisions on overseas investment are for individual companies to take in the light of market conditions. Government action has been aimed primarily at creating the right kind of climate in the recipient countries but some very limited practical support has been provided to companies undertaking specific investments.

3 Any decision to promote overseas investment more positively will be politically contentious, but the criticism that "overseas investment exports jobs" is misplaced. A large proportion of UK investment is in services, transport, mineral extraction and marketing where the alternative of exporting from the UK does not exist; in manufacturing, many companies invest in particular markets in order to achieve a larger market share than would otherwise be possible. On balance overseas investment promotes rather than substitutes for UK exports. For the UK economy as a whole the main benefit is the net return to the UK of profitable overseas operations. Officials see a liberal UK policy towards outward investment and inward investment as

consistent and beneficial to the UK. All our major competitors encourage outward investment in one way or another.

4 Officials believe that if liberal policies are pursued towards foreign investment and external trade, there will be clear net benefits for the host economy. Whilst direct investment can realistically only have a limited role to play in replacing existing historic debt, developing countries can ease future dependence on short term bank finance by encouraging private direct investment.

5 Whilst endorsing the view that decisions on overseas investment are essentially for individual companies, officials have identified a number of measures that could usefully be taken to encourage more positive attitudes both by companies and by recipient countries. The recommendations [set out in detail in paragraph 20 of the Report] include three key elements: a new scheme to promote overseas investment in developing countries (funded from the current gross aid programme); increasing the emphasis given by Government as a whole to the importance of outward investment; and improving the coherence and presentation of existing support schemes. If the recommendations are endorsed by Ministers officials should report back on the detailed implementation within the next 12 months.

REPORT OF WORKING GROUP ON DIRECT INVESTMENT OVERSEAS

Background

1 Following an exchange of minutes between the Secretary of State for Trade and Industry, the Foreign and Commonwealth Secretary and the Chancellor of the Exchequer in December 1983, an inter-Departmental working group of officials was set up under DTI Chairmanship to look at Government policy towards British private investment overseas. The establishment of the working group arose mainly from two particular concerns within Government about the relationship between investment, on the one hand, and exports and aid, on the other. The Group's terms of reference included a review of conditions for and experience of investment in a selected number of key countries, drawing heavily on the practical experiences of individual companies; a re-assessment of the impact of direct investment overseas on the economy of the UK and host countries; and consideration of whether, and if so how, additional Governmental support should be provided to encourage such investment.

Forms of Investment

2 Overseas investment takes many forms, from setting up a wholly owned subsidiary to portfolio investment in a company operating in a field totally unrelated to that of the investor. The working group confined its review to direct investment (ie investment involving a significant element of managerial control), but looked at many forms of such investment, including minority participation in joint ventures, the acquisition of whole or part of an existing company, and the establishment of a wholly or majority owned new subsidiary.

Extent of direct overseas investment

3 The UK has traditionally undertaken much more overseas direct investment than all other industrialised countries except the USA, although in recent years countries such as Japan and West Germany have been catching up (see Annex 1 fig 3). The total stock of UK direct investment stood, at the end of 1981 at £44 billion (fig 1), of which 40% was in North America, 19% in the European Community, 19% in the (primarily richer) developing countries and the balance mainly in the old Commonwealth countries; there is none to speak of in Japan. These figures of stocks of UK investment reflect traditional trading and commercial links, and looking at flows of new investment, which are considerably more volatile, the USA assumes even greater importance. Th flow of UK direct investment in 1982 was just over £2.5 billion, only half the figure in the previous year. Furthermore, much of the investment was funded by retained profits in overseas affiliates (£1.6 billion in 1982), while around £1 billion net was provided direct from the UK (Fig 4).

4 About 20% of the UK stock of our outward direct investment is in oil, and of the remainder about half is in manufacturing; other major sectors are: distribution; banking, insurance and financial services; property; mining and construction (fig 2).

5 UK direct investment in developing countries as a whole exceeded UK aid flows in 1980 and 1981, but the position was reversed in 1982 (fig 5). However direct investment tends to go to the richer developing countries while aid is directed primarily to the poorer. Viewed from the perspective of the developing world as a whole, the external financing requirements of non oil developing countries have predominantly been met by borrowings, both official and private, whilst direct investment and officials transfers (largely aid) have played proportionately a less significant part (fig 6).

Policy Implications

6 The Working Group paid particular attention to the impact of direct investment overseas on 3 areas of Government policy - export performance, aid policy and developing country indebtedness. About four fifths of UK direct investment is in other developed countries (about half in the United States). It is these countries comprising the UK's most important export markets which attract most investment. Direct investment is almost invariably market-driven.

7 As emphasized in the 1984 London Economic Summit Declaration, the encouragement of direct private investment in developing countries is important in the context of both aid policy and the strategy on debt. Private investment can be a potentially important means of supplementing, or in some cases replacing,other capital flows. In relation to the developing countries' current debt problems, direct investment can realistically have only a limited role in helping to replace existing, historic debt. However, for the future developing countries can help to reduce their dependence on short term bank finance by encouraging private direct investment to play a greater role in meeting their financing needs.

Present Policy

8 Government policy towards overseas investment has been broadly neutral. The Government have taken the view that decisions on overseas investment are for the investors to take, in the light of market conditions, and with the minimum of Government intervention. Annex 2 sets out existing HMG activities.

9 Government activity has taken two forms. The first has been activity aimed at creating the right kind of climate for investment in the recipient countries. Action has been taken to encourage the removal of existing barriers and the fostering of more open attitudes towards private investment. Considerable efforts are being made whenever practicable to negotiate bilateral Investment Promotion and Protection Agreements and Double Taxation Agreements. At the multilateral level, the UK has been active in trying to create a favourable climate for investment in both developing and developed countries, both by positive affirmation of the benefits of direct investment, particularly to developing countries, and by defending investors against attempts at excessive multilateral regulation of their activities.

10 The second form of activity has been in support of individual investors. Financial support has been given by ODA to the Commonwealth Development Corporation which is currently associated with some 30 private sector commercial and industrial companies in investments in developing countries. The UK has supported the capital increase for the International Finance Corporation, which seeks to co-operate with private sector companies from developed countries in investments in developing countries. Some financial assistance toward pre-investment studies has been available to companies under an ODA scheme, but the scheme has been little utilised in recent years. ODA have recently issued an internal Guidance Circular drawing attention to the importance of co-ordinating the use of aid funds with private direct investment. ECGD's investment insurance scheme provides cover against the political risks of investments such as expropriation; but this scheme has been little used. Some existing BOTB schemes are of marginal use to investors; but the emphasis of these schemes is very

much on support for direct exports from the UK. Finally, some assistance in obtaining basic information and establishing contacts is provided to prospective investors by the DTI and overseas Posts; but again existing services are focussed largely on the needs of direct exporters.

11 The removal of exchange controls in 1979 was a key element of Government policy on outward investment (although the initial main effect has been felt on portfolio investment) and internationally Ministers have frequently emphasised the importance of direct investment. This has not however been followed up at the practical level of support to British companies undertaking specific investments and Government measures have been fragmented, disparate and not coherently presented.

12 More positive presentation of existing support schemes and consideration of additional measures have both been inhibited by political constraints (as well as by the present Government's reliance on market forces as the major determinant of investment decisions). The criticism that "overseas investment exports jobs" is misplaced, because as we argue below, investment overseas is rarely a direct substitute for investment at home. But it must be recognised that any decision to encourage or promote overseas investment more actively than in the past is likely to be severely criticised by the Opposition on account of the alleged effect on employment. Outward investment has traditionally been a highly contentious political issue.

Economic Effects on UK

13 UK companies have invested overseas for a wide variety of reasons. Many have invested abroad in markets which they saw as having major potential, but which could not adequately be serviced by direct exports from the UK, due to formal and informal barriers to trade, transport costs, or the preference of local customers for locally-based suppliers. Other companies have invested abroad to extract raw materials, to supply transport or other services, and to distribute and market UK exports. However firms which have invested abroad in order to take advantage of lower production costs appear to be rare.

14 Nevertheless, despite the variety of reasons for foreign investment, the common driving force behind companies' decisions is the pursuit of profitability. Companies will invest abroad when, over the longer run, it promises an adequate return, which exceeds the return that would be expected from other possible uses of the investment resources. Equally, for the UK economy as a whole the primary benefit from overseas investment results from its profitability: the economy eventually gains command of more resources than are expended on the investment.

15 The Working Group considered the argument that overseas direct investment, whilst improving the profitability of UK companies, acts to the detriment of the economy as a whole by depriving the UK of investment resources and by "exporting jobs" but did not find it convincing. (See Annex 3). Not only is much of the finance for UK overseas direct investment raised abroad but the proportion that is financed at home is unlikely to worsen significantly the cost and availability of finance for domestic investments. As far as exports are concerned the available evidence - strongly supported by the results of the Working Group's

interviews with companies - indicates that in very few cases did the investing firm have the choice between investing overseas and investing at home to supply the overseas market by exporting. A large proportion of UK overseas investment is in services, transport, mineral extraction and marketing where the alternative of exporting does not exist; even in manufacturing, where the option of exporting may exist, many companies felt that their market share would have been much lower without a local manufacturing presence. Indeed, on balance taking into account UK exports of components and capital goods involved in the investment and the potential for marketing other products from the company's range, overseas investment appears to promote, rather than substitute for, UK exports.

16 The Working Group saw a liberal view on outward investment and inward investment as consistent. In a world of growing specialisation, to allow companies themselves to determine the most efficient geographical location of investment ensured the effective transfer of technology and management techniques which benefits both the UK economy as well as other countries. The accumulation of overseas assets by the UK in recent years will provide a continuing source of overseas earnings as North Sea oil production declines.

Economic Effects on Developing Countries

17 Whilst investment in developing countries from the UK amounts to only one fifth of our total overseas direct investment, the Group paid close attention to it because of its implications for our aid policy.

There are clear potential benefits in new capital on terms more flexible than short or medium term debt, foreign knowledge, experience, technology and skilled manpower, which can have effects on the host economy beyond the immediate investment. However, if the host country offers incentives and protection to would-be investors, these may serve to reduce or eliminate the benefits of such investment. Thus the benefits of private investment depend on the host Government's economic policies. There is every reason to think that if liberal policies are pursued towards both foreign investment and external trade, there will be net benefits for both the host economy and for the UK.

Competitors' Practices

18 All our major competitors encourage outward investment in one way or another, although the extent to which this is done and the means employed vary significantly. This aspect is dealt with in greater detail at Annex 4. There is no doubt that the underlying presumption of our major EC partners and the Japanese is that overseas investment, whilst involving some foreign exchange outflows, will bring long-term benefits to the economies of the investing countries.

Conclusion

19 The Working Group endorses the view that decisions on overseas investment are essentially for individual companies to take in the light of market conditions. However, the Group's review of selected markets revealed a clear need for Governmental action aimed at removing existing barriers and inhibitions and promoting more positive attitudes to

investment both by recipient countries and by many UK companies. The Working Group has examined existing support mechanisms and activities. It has concluded that, without affecting the main thrust of existing policy, a number of improvements can usefully be made. These relate particularly to the coherence of existing schemes and their presentation and to the emphasis given to investment issues by Government as a whole. Officials are not recommending a radical shift in policy, but some action on a political level would almost certainly be needed in order to provide the necessary impetus. A number of detailed measures have been identified, none of which would necessitate any additional financial provision. Many, but not all, of these are within the responsibility of the DTI as the Department with the lead role in promoting the UK's invisible as well as visible exports.

Recommendations

20 The Working Group's recommendations fall under 4 main headings:

(i) New direct investment overseas assistance scheme

The Group considered whether financial support should be offered to companies who were considering investing in a country for the first time. This first investment was seen as a major hurdle which deterred a wide range of companies, whereas once established in a market, companies were much better placed to identify and evaluate further investment opportunities. The Group considered however that such

assistance could not be justified for investment in developed countries, since the financial and political frameworks should be reasonably comprehensible and commercial relationships much easier to establish. However, greater difficulties were faced in developing countries and perhaps more importantly, the UK's Aid Policy objectives could be significantly advanced by a scheme aimed specifically at increasing the volume of UK investment and enhancing the economic impact on the host developing country. The outline of a scheme drawn up by ODA officials is set out at Annex 5. Support would be offered in two areas, first, the identification and appraisal of investment proposals (encompassing the extant but little utilised Pre-Investment Studies Scheme run by ODA), and second, in executing the investments in such a way as to increase their impact on manpower and institutional development (eg skill training, management training). Officials took differing views on the geographical coverage of the scheme. DTI felt that investments in all developing countries outside OPEC should be eligible for support, including the richer developing countries since these are likely to offer better opportunities for profitable investment and continuing overseas earnings by British companies.

ODA considered that aid funds should essentially be restricted to poorer developing countries in accordance with the general philosophy of the UK Aid Programme. They were prepared to accept the extension of the approval element of the scheme to middle income countries, but felt that support for activities at the execution stage should be restricted to projects in poor developing countries. The scheme would be administered by ODA and, given wide publicity, could spend in the region of £3m - £4m by its third or fourth year in operation with the funds coming from the gross aid programme.

(ii) <u>International Action</u>

(a) Following the emphasis given to the importance of direct investment in the 1984 London Economic Summit Declaration, continuing efforts should be made, both at high level meetings and in all other appropriate fora, to influence positively the climate for overseas investment and the attitudes adopted by developing countries. To this end the UK should continue to play an active role in OECD and other international fora. IMF and IBRD should be encouraged to put pressure on debtor countries to adopt policies more conducive to attracting foreign investment. The Commonwealth Development Corporation should continue to promote investment in partnership with British companies within existing guidelines. Efforts should also be made to promote a greater awareness amongst UK manufacturing companies of the actives of the International Finance Corporation and of potential collaboration on investment projects in developing countries.

(b) Investment questions should also be pursued on a bilateral basis as appropriate. A continuing programme of Investment Promotion and Protection Agreements should be implemented; and where possible new Double Taxation Agreements should be negotiated in addition to the regular revision of existing Agreements. Representations about specific difficulties encountered by investors should be made as necessary. Wherever possible the desirability of positive attitudes to foreign investment by host countries should be pressed in Ministerial speeches and on other suitable occasions.

(iii) <u>Reordering of priorities in the UK</u>

(a) The Government should promote an increased awareness in the UK of the benefits of overseas investment. In particular, all suitable opportunities should be taken (eg Ministerial speeches) to encourage British companies to consider worthwhile possibilities for investment.

(b) Within the DTI officials should focus to a greater extent on the needs of prospective investors, and should in particular improve their capacity to provide companies with details or sources of basic information. Inevitably there are

limits to the resources which can be devoted to this purpose, but in many cases information is readily available from the investment promotion agencies of recipient countries.

(c) DTI officials should consider on an ad hoc basis the need for initiatives and promotional activity related to specific countries.

(d) ECGD should continue to promote usage of the Investment Insurance Scheme in the wake of improvements made in the scheme towards the end of 1983 with their attendant publicity.

(e) Inland Revenue should continue to monitor the implications of tax arrangements for expatriates participating in UK pension schemes, with a view to improving consistency, where appropriate through Double Taxation Agreements.

(f) A BOTB leaflet should be produced on the subject of outward investment. This might include a short statement of Government policy, give details of the new investment assistance scheme to be introduced by ODA (and other existing schemes relevant to investors), and indicate sources of information and

advice to investors. Such a leaflet could be presented as responding to the call that has occasionally been made for the establishment of a one-stop reference point within Whitehall for information on outward investment matters.

(iv) Reordering of priorities overseas

(a) DSP instructions should be revised in order to draw the attention of Heads of Posts to the importance which Ministers attach to outward investment work and the need to re-examine in the light of local market conditions the balance between investment work and export promotion. We recognise that where a higher profile for investment is appropriate, the emphasis of commercial officers' other work will have to be adjusted accordingly. Such changes will require commercial officers to increase significantly their capability for putting prospective investors in touch with relevant local contacts, including Government authorities, professional advisors, experienced businessmen already in the market and, in particular, prospective partners. Posts should take account of local involvement in this field by banks, accountants, Chambers of Commerce and other non-official organisations. Promotional activity should be considered on an ad hoc basis. Extension of the activities of

the Business Executive Service Overseas to include provision of retired expatriates to provide advice on investment matters should also be examined.

(b) In addition to the ODA scheme proposed in (i) above, greater attention should be devoted to the positive results likely to accrue from a greater linkage between Governmental aid and private investment. ODA's recent internal Guidance Circular should be drawn to Posts' special attention and should be followed up by efforts to improve liaison between UK officials overseas concerned with aid and trade matters. Efforts should be made to ensure that the inter-relationship between aid and private investment - and the potential benefits - are understood both by British companies and officials of host Governments. ODA should examine the scope for increasing the number of training opportunities for private sector personnel, and as appropriate specifically targetted technical and commercial training.

21 The recommendations set out above, whilst not individually of major importance, will call for a significant change in attitudes by officials in the relevant Departments. If the recommendations are endorsed by Ministers it is therefore suggested that the lead Departments (principally DTI, Treasury, FCO and ODA) should be invited to report back to Ministers on implementation of the recommendations in 6/12 months time.

DTI
July 1984

UK OUTWARD DIRECT INVESTMENT
BOOK VALUE OF NET ASSETS AT END 1981

BY AREA

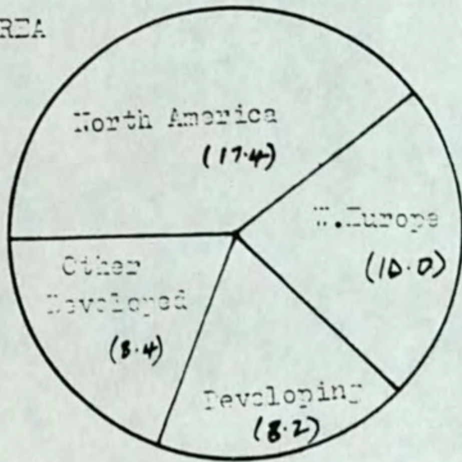

FIG. 1

(£ Billion)

BY SECTOR

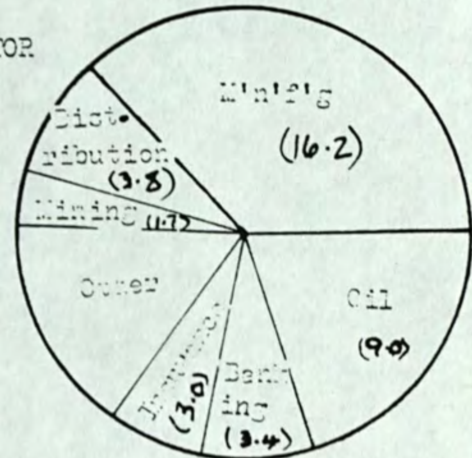

FIG. 2

STOCK OF FOREIGN
DIRECT INVESTMENT HELD
OVERSEAS BY DEVELOPED
COUNTRIES

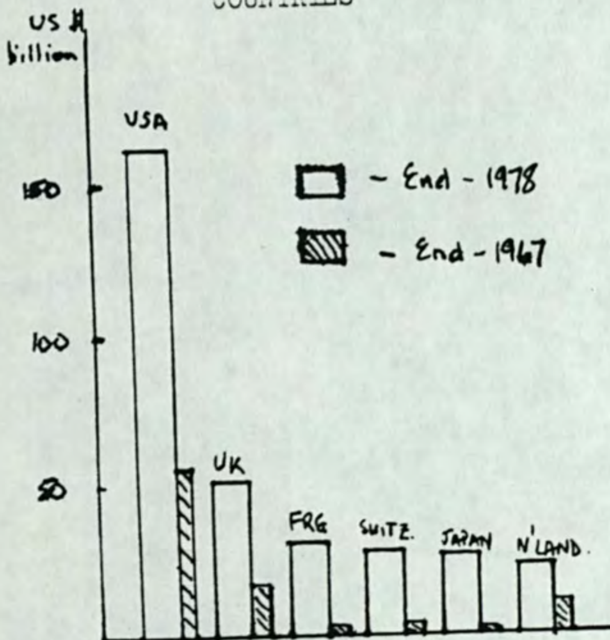

FIG. 3

UK DIRECT INVESTMENT
OVERSEAS (EXCL. OIL)
1982

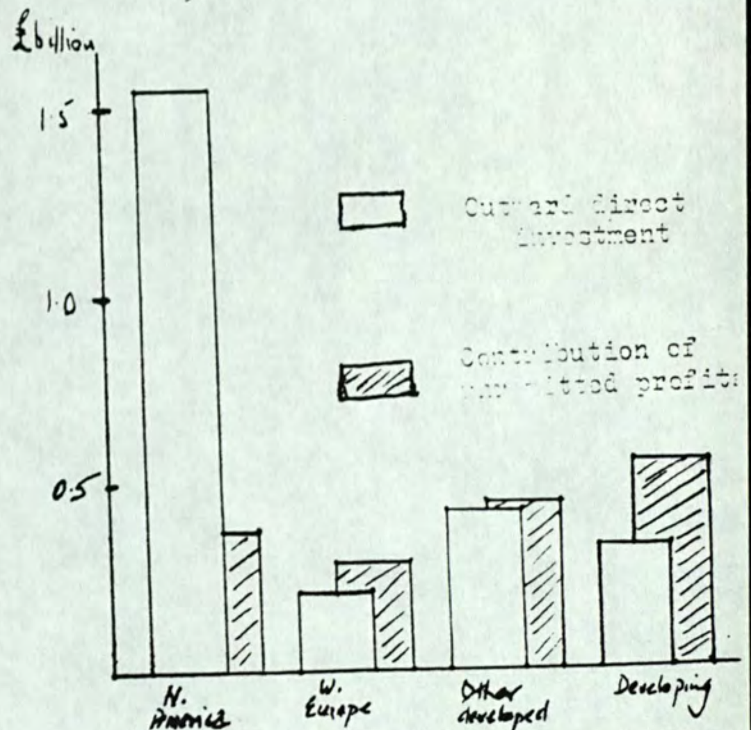

FIG. 4

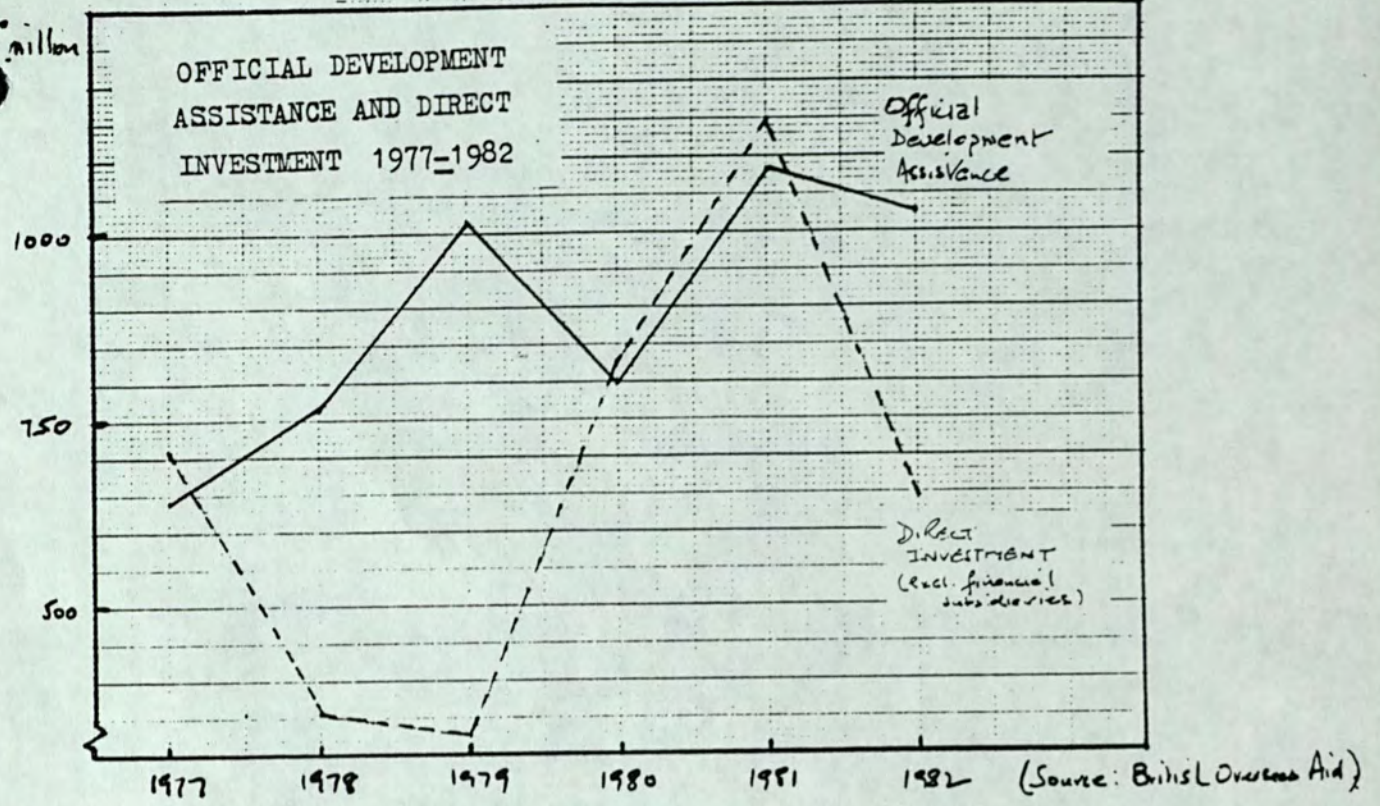

FIG 5

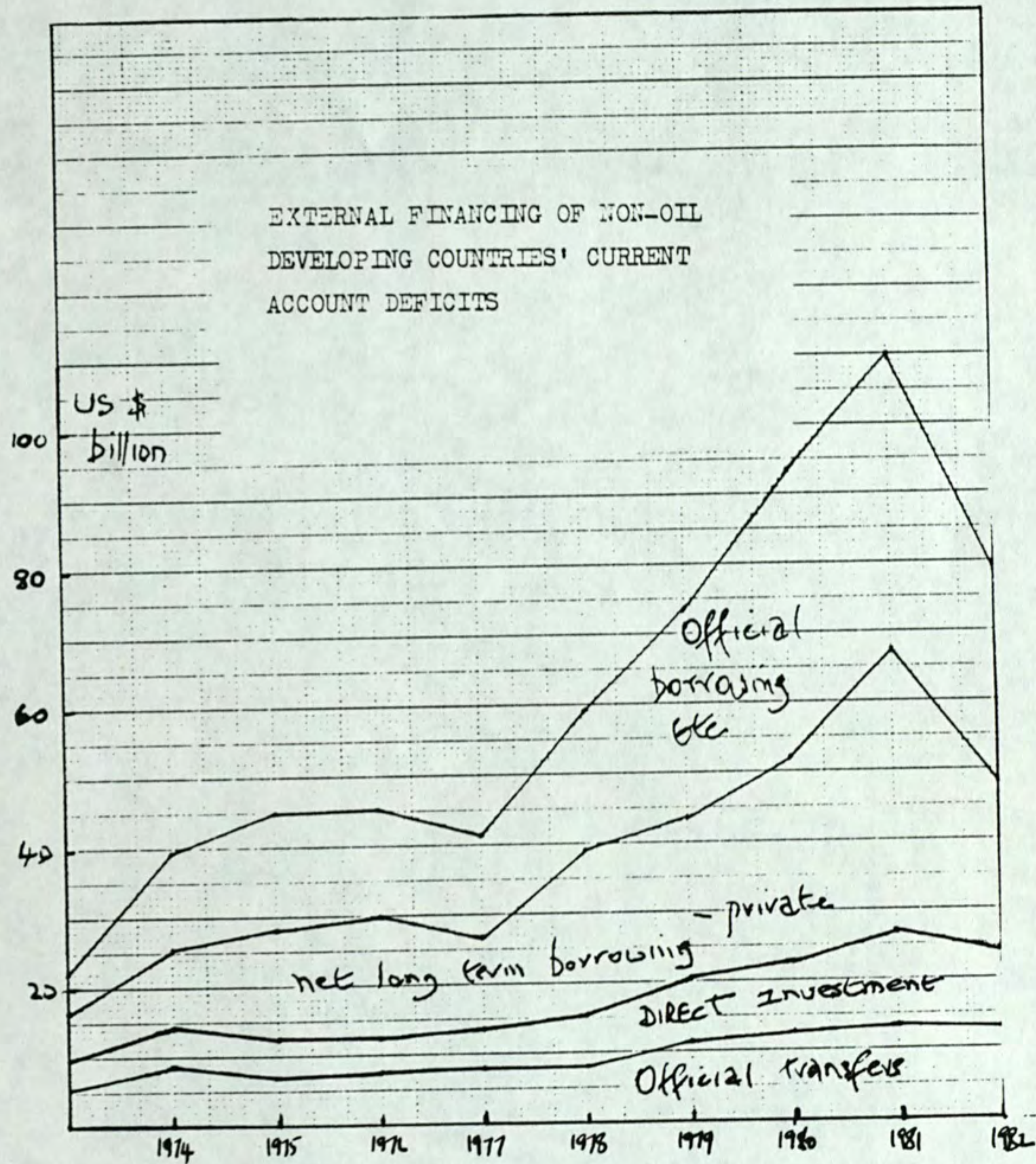

Fig 6

EXISTING HMG ACTIVITIES RELEVANT TO OVERSEAS INVESTMENT

BRITISH DIRECT PRIVATE INVESTMENT AND THE AID PROGRAMME

1 Linkage between the aid programme and private direct investment has three strands: the Commonwealth Development Corporation (CDC), specific linkages between bilateral country aid programmes and specific private investments, and the Pre-Investment Study Scheme (PISS).

ODA's PRE INVESTMENT STUDIES SCHEME (PISS)

2 ODA operate a scheme to encourage UK firms to investigate investment opportunities in developing countries by underwriting 50% of the costs (up to £50k) of a pre-investment study, payment being made if the firm subsequently decides not to go ahead with the investment. PISS has a low profile and has been little used: the question of its future was raised in 1982 and the possibility of transferring the scheme to the Department of Trade and Industry was under active discussion last year, but subsequently put on ice pending the report of the Working Group.

THE COMMONWEALTH DEVELOPMENT CORPORATION (CDC)

3 The CDC promotes economic development by investing in commercial projects in the developing countries. The Corporation is currently associated with some 40 UK private sector companies. The bulk of these projects are concerned with the production and processing of raw materials but there are also a number of manufacturing ventures, infrastructure and hotels. Following the 1981 inter-departmental review of its activities, the CDC's overall borrowing limit was raised to £700m and a higher priority was accorded to joint ventures with the private sector.

BRITISH EXECUTIVE SERVICE OVERSEAS (BESO)

4 BESO sends experienced businessmen (usually retired, but occasionally secondees) to provide advice to small and medium-sized indigenous businesses and governments of developing countries, for 3-4 month tours. BESO, an independent organisation part-funded by ODA, meets the UK expenses of the programme, overseas costs are borne by host organisations.

ECGD'S OVERSEAS INVESTMENT INSURANCE SCHEME

5 As in most OECD countries, ECGD operate a scheme to provide UK investors with insurance for up to 15 years against the risks of expropriation, war, restrictions on remittances and other non-commercial risks in respect of new investment overseas. Although the Scheme was intended to apply mainly to developing countries, cover is in principal available on any country. In 12 years of operation, the total volume of business covered - £170m of investments involving 341 applications - has been disappointing. ECGD have recently acted to improve coverage and reduce premiums, as well as launching a publicity initiative designed to increase business. For the longer term they are also discussing collaboration with the private sector insurance market.

BOTB SUPPORT SCHEMES

6 A number of the BOTB schemes, primarily aimed at export promotion, may be of limited relevance to outward investment. In general however it would be difficult to stretch the schemes to cover areas for which they were not really intended.

7 Perhaps most pertinent is the Export Marketing Research Scheme (EMRS) which offers 50% grants to cover the commissioning of consultants or in-house travel and subsistence undertaken for market research to promote UK exports. This could apply to outward investment where research indicates that this is the best way to enter a particular market.

8 Under the Market Entry Guarantee Scheme (MEGS) companies can receive 50% of their overhead costs eg office rental, salaries, travel (up to a maximum of £300k) of breaking into a new export market, recoverable by a levy on sales. This scheme does not lend itself to supporting outward investment unless significant UK exports are involved.

9 The Export Intelligence Service (EIS) a computer based system of information dissemination carries some information on opportunities for co-operation with overseas firms, reported by Posts. From an investment point of view this is generally felt to be insufficiently selective in targetting companies interested in particular sectors and markets.

10 In certain circumstances support for seminars, exhibitions, visits etc. might be made available under other BOTB services, such as the Outward Mission Scheme.

INVESTMENT PROMOTION AND PROTECTION AGREEMENTS (IPPAs)

11 The FCO, in consultation with interested Departments, undertakes a continuing programme of negotiating bilateral IPPAs. IPPAs are intended to stimulate the flow of investment between the two signatory states; to protect existing and future investments under the law of the host country; and in the event of expropriation by a host government, to ensure that prompt, adequate and effective compensation is paid. They also provide for independent settlement of investment disputes. 22 IPPAs have been negotiated to date, 16 since 1979. FCO has a list of priority countries for further agreements, but the process is in large part demand-led.

DOUBLE TAXATION AGREEMENTS (DTAs)

12 The UK tax system incorporates arrangements for preventing double taxation of the same income by giving relief for overseas tax against UK tax. The UK has negotiated comprehensive double taxation agreements with some 80 overseas countries under which each country has agreed to give up or to reduce its tax in certain circumstances. In some cases "matching credit" provisions are included in order to avoid developing countries being penalised for tax incentives offered as encouragement to investors. Where relief is not due under an agreement, relief in respect of foreign taxes is given unilaterally against the UK tax on the same income in question. The effect of these arrangements is that the UK resident has broadly the same tax burden on income arising overseas as on income arising in this country, provided that the overseas rate of tax is not higher than the UK rate .

Projects and Export Policy Division
Department of Trade and Industry
June 1984

Annex 3

DIRECT INVESTMENT OVERSEAS - ECONOMIC COSTS AND BENEFITS

Benefits to UK

1. Firms undertake investment abroad for a wide variety of reasons: to extract raw materials, to supply transport or other services, to take advantage of lower production costs abroad than in the UK in some industries, to distribute and market exports, and to trade in markets where tariffs, restrictions, or the pressure of competition makes exporting impracticable.

2. But common to all these reasons is the pursuit of profitability Firms will invest abroad when, over the longer run, the expected return more than outweighs the cost of the investment resources used, and when the profits to be made from overseas investment are expected to be greater than the profits that could be made from other uses of the investment resources.

3. For the UK national economy as a whole, too, the profitability of overseas investment is the primary benefit from such investment. In general, if an investment is profitable the economy eventually gains command of more resources than are expended on the investment.

4. There may be situations where profitability does not fully reflect the costs and benefits of direct investment abroad to the national economy. Thus it has been argued that direct investment overseas deprives the UK of investment resources. investment in the UK could be reduced by overseas investment if firms undertake investment overseas as an alternative, or "substitute" for domestic investment. Moreover, even if an individual firm's investment decisions at home and abroad are made independently, increased investment abroad by UK firms might increase the cost of investment finance to other UK investors - and thus reduce the amount they were prepared to invest at home. In this way, it is contended that foreign investment "exports jobs" to the detriment of the UK economy as whole.

Annex 3

Does overseas investment deprive the UK of investment resources?

5. Do firms regard domestic investment and overseas investment as alternatives? An individual business may have to choose between domestic and overseas investment if it is constrained by a fixed level of financial resources. Small firms may be. Most firms however are not constrained to a fixed level of investment resources certainly not in the time periods over which foreign direct investmen is conceived. In the short to medium term they usually have the option of raising additional finance - sometimes at a price - by borrowing, while in the long run any gearing problems can be relieved by the issue of equity.

6. The firm's investment choice may lie between siting a particula production facility in the UK or abroad. However the functions performed by overseas investments in mining, services, distribution and transport - about 50% of direct overseas investment - could not be performed by investment in the UK. "Substitution" of this sort seems likely to arise in manufacturing. Even in manufacturing there may not always be a choice between UK production for export and overseas investment. The investment might be one which would be unprofitable in the UK (eg some electrical assembly activities), or the option of exporting may be ruled out by the presence of import restrictions (or preference for local production) in the overseas market. In a recent study of UK overseas direct investment in manufacturing, Professor Silberston concluded that "in the absence of overseas investment, only a fraction of the relevant overseas output would have been produced in the UK: in no sense has overseas investment been a simple substitute for investment in Britain".

7. Does investment abroad indirectly reduce investment at home, through raising the cost of investment finance for everybody? The upward impact of overseas investment on domestic interest rates is probably small. Much overseas investment is financed either by borrowing overseas, or from the retained profits of existing overseas operations, and therefore does not result in increased demand for domestic investment finance. Even if an increase in domestic demand

for investment finance would initially lead to a rise in domestic interest rates, relative to foreign rates, it is unlikely that significant differences in interest rates would persist. The higher domestic interest rate would lead to shifts in the portfolios of international investors, who would try to lend more and to borrow less in the UK market.

Does investment overseas "export jobs"?

8. If investment in the UK is unlikely to be displaced and the cost of domestic funds unlikely to be significantly affected by direct investment overseas, UK employment also should not be adversely affected. However, jobs might be affected if outward capital flows were to reduce UK exports on balance. The effect on exports depends on the reasons why investment is undertaken and therefore to a large extent on the type of investment. Foreign investment itself is, if anything, likely to directly generate extra exports of UK capital goods. Subsequently if it is invested in mineral extraction or services abroad (eg banking, insurance, transport) it is not likely to affect UK exports, while investment in distribution systems (or assembly facilities) could increase exports of finished goods (or components). On the other hand, investment - mainly in manufacturing - to take advantage of lower production costs abroad may displace UK exports but only if it is thought that UK exporting i likely to be viable in the long run against the advantage of the foreign location.

9. It is not easy to judge the net effect on UK exports as a whole, initially and subsequently. On balance - given the particular and stable pattern of UK foreign investment (50% has gone into mining, services and distribution) - the conclusion of the Reddaway study (completed in the 1960s) seems still likely to be valid - that on average the effect on exports is small but positive.

10. The effects on the exchange rate are also relevant. The initial capital outflows (if the investment is financed in the UK) will tend to depress the exchange rate. This will work to offset

upward pressure on the exchange rate from any increased capital inflows and may stimulate extra UK exports.

11. Overall therefore it seems highly unlikely when all consequences are taken into account that increased direct investment by the UK will cause any loss of jobs while in the long run the economy will benefit from the higher profitability of the overseas operations.

Does investment abroad benefit developing countries?

12. Much UK overseas direct investment is to other developed countries. But a significant proportion - about a fifth - is in Less Developed Countries. This brings not only new capital to developing countries but also foreign knowledge, experience and technology as well as technical and managerial personnel which are not always locally available. The potential benefits of private capital inflows can accrue to the domestic labour force via higher wages than they were getting before. Domestic consumers gain through the availability of preferred products or products at lower prices. The host government gets tax revenues. Foreign owned investment may also yield "external"economies or diseconomies. For example, personnel who have trained or gained management skills in foreign firms may then be employed by domestically owned firms and local sub contracted firms gain advice and know-how. It is also possible of course for foreign firms to benefit from locally trained personnel.

14. The impact of foreign investment on both the current and the capital accounts of the balance of payments is not likely to be a significant element in the costs and benefits of particular investments. However from a short period viewpoint direct investment is less likely to impose liquidity problems on an economy to the extent that profit-remittances on the equity elements are likely to be more flexible than interest on debt and may fluctuate more in tune with domestic or world activity and hence with the country's balance of payments position.

18. The extent to which foreign investment makes a country economically better-off or worse-off in practice will depend crucially on the scale of the host country incentives or protection offered to the investor in any particular domestic sector of its economy. It is therefore the policies of each developing country in this respect which are crucial to a general or specific judgement about the net benefits of foreign direct investment. The very policies which make investment attractive to foreigners may be responsible for such investments being marginally beneficial or even harmful economically. The question of how much protection or subsidy is offered is very much a policy matter over which the host government has control. There is every reason to think that if liberal policies are pursued towards both foreign investment and external trade by developing country governments there will be net benefits for both the host economy and for the UK.

Ec2 Division
Department of Trade and Industry
15 June 1984

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Annex 4

WORKING GROUP ON DIRECT INVESTMENT OVERSEAS

COMPETITORS' PRACTICES IN SUPPORT OF OVERSEAS INVESTMENT

Introduction

1 This note describes the main types of schemes run by the UK's major competitors in support of direct investment overseas. It deals only with specific schemes and services available to individual companies and does not cover government activity or measures (eg Investment Promotion and Protection Agreements, exchange controls) which have already been dealt with elsewhere.

2 Substantial work has been undertaken in this area in the past, notably by OECD and, within the UK, by a Treasury-chaired Working Party on Overseas Investment which reported in January 1982. Officials have not therefore gone over this ground in detail again. Visits by the DTI Review Team to the United States and France were used to verify and update information about the policies and schemes of those countries, whilst the review team's other visits afforded some/limited opportunity to look at the activities and support schemes of the UK's major competitors.

3 This paper does not therefore provide a comprehensive catalogue of all support schemes. It simply describes the main types of schemes available and gives a few selective examples of specific activities or schemes. It is hoped that this overview of competitors' activities will provide a useful yardstick against which to measure UK efforts.

Types of Schemes

4 Support schemes fall into 5 main categories:

(i) Investment Insurance Schemes

All member countries of OECD's Development Assistance Committee operate investment guarantee schemes of general

application covering non-commercial risks such as expropriation, war and transfer risks. In France, for example, there are two government schemes for investment insurance - one run by COFACE and dependent upon the company giving guarantees regarding continuing and indeed increased exports from France; the other run by the Banque Française du Commerce Extérieur (BFCE) which in addition to the usual risks also provides cover against violation by the foreign authorities of any specific undertakings given concerning the investment.

(ii) Schemes for Financing Feasibility Studies

Many countries provide financial support towards the cost of feasibility studies. Schemes vary considerably but support typically amounts to 50% of the costs, repayable if the project goes ahead. The orientation of different countries' schemes varies considerably. Some schemes concentrate assistance on smaller and medium sized companies some schemes are directed towards particular types of investment such as the securing of supplies of raw materials; some schemes have a particular geographical orientation.

(iii) Financial Support

Many countries provide financial support to promote overseas investment; the means employed and the amount of resources made available vary significantly. In France and in Japan official financial support, usually in the form of medium or long term loans at favourable rates of interest, is available through a variety of organisations. In the FRG the German Development Co (DEG) can take equity in or provide loans for overseas investment projects. In the US the Overseas Private Investment Corporation (OPIC) provides loans and loan guarantees for small companies investing in selected projects in developing countries.

(iv) Fiscal Incentives

In addition to taking measures to eliminate or reduce double taxation, many countries give fiscal concessions to promote overseas investment through a branch or subsidiary. In the FRG fiscal provisions are regarded as a major part of the total overseas investment promotion effort; taxable profits of the investing company may be retained for a period of 6 years in order to build up reserves in a developing country for investment there with attractive tax allowances. In France a tax free reserve equal to 50% of the amount of capital invested during the first 5 years of operation can be established, to be re-integrated into taxable profits of the investing company during the second 5 years.

(v) Information and Promotional Activities

Whilst most developed countries provide information on investment opportunities alongside conventional reporting of export opportunities, some countries have developed information systems specifically for investment opportunit: In the United States OPIC publishes a series of investment information packs on specific countries; it also collates and circulates information about specific investment opportunities and sponsors investment missions overseas on a selective basis.

5 All developed countries thus provide substantial practical support to their companies' overseas investment activities. The emphasis as well as the detail of different countries' schemes varies significantly. The Review Team's visits to France and the United States provided an interesting contrast in attitudes to overseas investment. Whilst support given to US companies is concentrated exclusively on developing countries, in France the main priority is to promote investment in other developed countries. It was made clear that the French government views overseas investment predominantly not in a developing country context, but as a means of promoting French economic interests in developed markets. The French and US attitudes probably represent the extremes of the spectrum, with other developed countries falling somewhere in between.

Conclusion

6 It is difficult to assess the importance and effectiveness of the various support schemes outlined in this paper and it is not possible to draw any categoric conclusions about the practices of our major competitors in comparison with UK measures. The Review carried out by the present Working Group suggests that taken as a whole our major competitors are probably more active and provide a more comprehensive range of schemes in support of overseas investment than the UK.

Annex 5

OUTLINE OF A SCHEME FOR SUPPORTING BRITISH PRIVATE INVESTMENT IN THE DEVELOPING WORLD

Background

The Working Party has recognised the potentially important contribution that private direct investment can make to the economic development of LDCs, provided recipient government policies are appropriate.

2. The potential merits of private direct investment include

(i) helping to develop the directly productive sectors in developing countries;

(ii) producing a flow of external finance and skills and techniques not otherwise available so effectively;

(iii) requiring return financial flows only if the enterprise is successful - a distinct virtue compared to portfolio loans.

3. There are currently two particular instruments operating within the aid programme used to stimulate UK private direct investme in developing countries. First, the Commonwealth Development Corporation, 13% of whose investments involve co-financing with British industrial companies. Second, a small Pre-Investment Studies Scheme run by ODA, which finances 50% of the cost of feasibility studies if these do not lead to subsequent investment. This has been little used in recent years. The ODA encouraged by the consideration of the interdepartmental group propose to consider setting up a new scheme absorbing the Pre-Investment Studies Scheme.

4. Features of this scheme are outlined below but these are tentative at this stage and ODA Ministers still need to be consulted, should Ministers approve the proposal in principle. We would then expect to discuss the way in which the scheme would operate with representatives of the UK private sector.

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Scheme Objectives

5. The objective of the schemes would be two fold; firstly to increase the volume of British direct investment in the developing world, in particular that investment which would be both economicall beneficial to the recipient and directly or indirectly commercially beneficial to the UK; and secondly to increase the benefit accruing to recipient countries and to the UK investor in terms of appropria manpower skills and local institutional development.

Scope of the Scheme

6. The scheme would use aid funds to support specific activities concerned with identifying, appraising and running new investment projects. It would have two discrete elements which could, but need not, be applied sequentially to the same project.

(i) First financial support for certain activities usually undertaken prior to any decision by the UK firm to invest. These would include the initial identification of opportunitie for pre-feasibility studies, for detailed investment appraisal and, where relevant, field trials related to possible new investment. Normally the work would be undertaken by the potential investor either by consultants, or by his own staff, or by some combination of the two. [It would incorporate the existing Pre-Investment Studies Scheme run by ODA and would need to avoid any overlap with the Export Market Research Scheme and the Market Entry Guarantee Scheme, both run by DTI.]

(ii) Second financial support for improving (specific features of) the implementation and operation of investments after a decision to invest has been made. These would cover skills training for local staff (locally or in the UK), manage ment development (locally or in the UK), certain types of training for expatriates (eg courses at the International Briefing Centre at Farnham Castle) adopting Western technology to suit local conditions and encouraging the development of indigenous developing country suppliers of inputs for the investment activity (eg the supply of packaging material for the product of the investment). This support should improve the economic benefits to the recipient as well as benefits to the investor and thereby commercial benefits to the UK.

Scheme Coverage

7. Geographical: ODA consider that the appraisal element of the scheme should be restricted to lower and middle income developing countries, and that support for activities at the execution stage should be restricted to projects in the poorer developing countries. DTI consider that both elements of the scheme should be available in all developing countries outside OPEC. The criteria used would favour help for projects in countries whose general policies were not prejudicial to economically and financially successful foreign investment.

8. Type of investment: Support would normally be limited to the first direct investment by the British company concerned in the particular country. Also any investor receiving assistance would be expected to have his own funds involved in the project - usually as equity - considerably in excess of the amount of assistance offered under the scheme. Any economic sector would be eligible; but certain types of activity (eg establishing a local distribution agency only) might need to be excluded. All proposals would be subject to some form of individual appraisal (see below).

9. Company: Only British companies (to be defined) or local companies in which there is a substantial investment by a British company would be eligible for help. Particular efforts would be made to interest companies with limited operational experience overseas.

Terms of Assistance

10. For pre-investment decision support for the funding arrangement would be the same as that offered under the existing ODA Pre-Investment Studies Scheme - that is 50% of costs likely to be incurred would be made available to the company. This would be refunded by the company if the investment concerned goes ahead. Prior to offering support for pre-feasibility and appraisal studies, there should be a presumption that the project being investigated was likely to be economically and financially viable.

11. For assistance at the post-investment decision stage the investor and the ODA would agree on their respective contributions to the proposed activities. ODA funding of up to 100% of the cost of specific activities would be possible. Support at this stage would depend on a broad assessment of economic and financial viability.

12. Unless the British Diplomatic Post in the country concerned advised to the contrary the authorities in recipient countries would not require to be consulted about the support being provided. The investor would, of course, need to observe all the normal procedures for foreign investors in the country concerned.

Source of Finance and Administration

13. The scheme would be financed within the aid programme, from a specific provision outside the individual bilateral country allocation. A small section in ODA would need to be created to deal full time with operating the scheme, in particular answering queries, assessing applications, and monitoring the use of aid funds. Professional advice would be sought from within the ODA, from other relevant departments and institutions.

14. The scheme would be publicised widely. Guidelines would be produced to be distributed both to relevant bodies (eg CBI) and to those particular companies who expressed an interest.

15. The details of the scheme would need to be worked out in consultation with private sector representatives. This could be done with an aim of launching the scheme in April 1985.

16. Demand for finance is very difficult to predict though the requirements could be expected to grow steadily over three or four years. The ODA envisage that costs up to £3-4m per year should be provided on the merits of the cases put forward and without an overall financial ceiling opeating. Above that level, if the demand emerges, the scheme should be operated within annual financial ceilings. Given the uncertainty in this area the financia provision and the methods of operation will need to be assessed 6-18 months after it has begun.

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