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Attracting Sustainable FDI in ASEAN:

# BUSINESS ENVIRONMENT AS A KEY DRIVER

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October 2020

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*Cover photo:* ***Factory workers in Vietnam***
Nguyen Duc Hieu



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| | |
|---|---|
| **ADB** | Asian Development Bank |
| **ASEAN** | Association of Southeast Asian Nations |
| **AFAS** | ASEAN Framework Agreement on Services |
| **CIT** | Corporate income tax |
| **CLMV** | Cambodia, Laos, Myanmar, Vietnam |
| **CPI** | Corruption Perceptions Index |
| **CSO** | Civil society organization |
| **FDI** | Foreign direct investment |
| **GDP** | Gross domestic product |
| **HDI** | Human Development Index |
| **HR** | Human resources |
| **IMF** | International Monetary Fund |
| **IPR** | Intellectual property rights |
| **MNC** | Multinational corporation |
| **NGO** | Non-governmental organization |
| **PPP** | Purchasing power parity |
| **OECD** | Organisation for Economic Co-operation and Development |
| **OFDI** | Outward foreign direct investment |
| **R&D** | Research and development |
| **RESP** | Rapid Emergency Supplies Provision (Philippines) |
| **SDGs** | Sustainable Development Goals |
| **SMEs** | Small and medium-sized enterprises |
| **SPE** | Special purpose entity |
| **TRIPS** | Trade-Related Aspects of Intellectual Property Rights |
| **UNCTAD** | United Nations Conference on Trade and Development |
| **UNDP** | United Nations Development Programme |
| **UNU-WIDER** | United Nations University World Institute for Development Economics Research |
| **VEPR** | Vietnam Institute for Economic and Policy Research |
| **VATJ** | Vietnam Alliance for Tax Justice |
| **WEF** | World Economic Forum |



# EXECUTIVE SUMMARY

After a period of decline in 2014–16, flows of foreign direct investment (FDI) in the Association of Southeast Asian Nations (ASEAN) region have followed an upward trend in recent years. In the three years from 2016, FDI flows into the 10 ASEAN countries increased by more than 40% in absolute terms and by 200% in terms of their share of global FDI flows. However, with the COVID-19 pandemic and the subsequent global economic downturn, FDI inflows into developing countries in Asia are predicted to decrease by 30–40%, leading to reductions in the tax revenues collected from corporate income taxes (UNCTAD, 2020).

The manufacturing sector remains the biggest destination for FDI flows in ASEAN, contributing 35.8% of total flows and recording an increase of 72.8% in 2018. FDI in some important service industries, by contrast, fell over the same period. FDI in the real estate sector declined slightly, while the finance and insurance industry and the wholesale and retail industry both experienced considerable decreases. In 2018, intra-ASEAN investment accounted for 15.9% of total FDI in the region and became its single most important source of inward investment, displacing the USA. However, a significant proportion of intra-regional investment was initially directed towards Singapore, to be reinvested later in other countries (ASEAN Secretariat and UNCTAD, 2019).

Evidence from previous studies suggests that a number of factors relating to the business environment have had positive effects on companies' choices of location for FDI. Macro-economic factors such as the inflation rate, economic freedom, and trade liberalization have statistically significant relationships with FDI flows (Demirhan and Masca, 2008; Ghazalian and Amponsem, 2019; OECD, 2019). Studies on the impact of the quality of institutions on FDI reveal that poor governance is a critical factor leading to low levels of inflows (Wei, 2000; Kaufman et al., 1999). Efforts to boost market development may also help ASEAN countries to attract more FDI (Hoang and Bui, 2015; Soumaré and Tchana Tchana, 2015; Parcon, 2008). This paper shows that many indicators of the macro-economic environment, institutional quality, and market development also appear to be positively correlated with FDI flows. Economic freedom, ease of doing business, market size, and human development are the factors that have the strongest relationships with decisions made by foreign investors.

Singapore and Brunei both have sound macro-economic conditions and conducive business environments, but they differ dramatically in the levels of FDI inflows they attract. As one of the largest tax havens in Asia, it is not surprising that Singapore accounts for a majority of the region's total inward FDI. Oxfam (2016) ranks Singapore as the world's fifth worst and Asia's worst corporate tax haven due to its harmful corporate tax policies that cause a huge amount of budget revenue loss for its own economy as well as those of other countries. The growing use of special purpose entities (SPEs) in Singapore as a gateway for FDI from outside the region is detrimental to the tax base of other ASEAN countries (Damgaard and Elkjaer, 2017). Brunei, on the other hand, receives the lowest amount of inward FDI of any ASEAN country, despite the generous tax incentives it offers. This disparity can be explained by the fact that Brunei has the smallest market size in the region – a factor that has a robust correlation with FDI flows.

Indonesia, Malaysia, the Philippines, Thailand, and Vietnam are comparable to one another in terms both of their business environments and the amounts of FDI they attract. Although substantial efforts are still required to improve their business environments, these five countries have relatively enabling environments compared with the region as a whole. With relatively skilled and educated labor pools, these countries attract a huge amount of manufacturing FDI from East Asian countries, as well as from the United States.

Cambodia, Laos, and Myanmar are falling behind, however, with low levels of FDI and less conducive business environments. The lack of skilled labor in these three countries puts them at a disadvantage when it comes to attracting labor-intensive manufacturing industries. Poor institutional quality in these three countries is one reason for their dependence on Chinese FDI, which tends to be attracted to resource-rich countries with low levels of governance (Kolstad and Wiig, 2012).

Despite evidence pointing to the significant impacts of business environment factors on attracting FDI, ASEAN countries have tended to engage in a 'race to the bottom' by aggressively offering incentives, rather than working to enhance their business environments (Oxfam, 2016). By offering generous tax incentives to attract investment, ASEAN countries have created an unfair environment for small and medium-sized enterprises (SMEs) and have sacrificed large amounts of their national budgets in the process. Moreover, there is no concrete evidence that tax incentives actually influence the decisions made by foreign investors about investment locations (James, 2014).

In addition to tax incentives, there is also intense competition between ASEAN countries to attract FDI by offering a wide range of non-tax incentives, including land incentives, employment and training supports, and financial incentives. This competition is focused to a large extent on land incentives, which harm local societies and widen socio-economic disparities (Prachvuthy, 2011). Furthermore, the opaque nature of the mechanisms involved in granting land incentives in Cambodia, Laos, and Myanmar create opportunities for corruption and rent-seeking (Hanssen, 2007). In addition to offering land incentives, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam are also competing vigorously on employment and training supports, financial incentives, and certain other non-tax incentives such as the facilitation of entry visas and migration and discounts on the costs of equipment. Employment and training supports aim to relieve the financial stress often faced by SMEs when providing training programs, which can have positive knowledge and technology spillovers in host countries (Moran, 2005). However, no evidence from previous studies suggests any significant impacts of such non-tax incentives on companies' choices of location for FDI.

Coordinated efforts by ASEAN countries are urgently needed to stop the harmful race to the bottom caused by these redundant incentive packages. Aggressively offering investment incentives may put a government at risk of fiscal drains during the COVID-19 pandemic. At the same time as a projected decline in FDI inflows, healthcare services and social safety net programs now also require extra spending by governments. The Philippines, for example, has spent US$5m on its Rapid Emergency Supplies Provision (RESP) project, which provides food for households and workers in the Luzon region. Indonesia has supported its health sector in the COVID-19 response with spending of $3m on medical equipment and supplies (ASEAN, 2020). Growing demands for additional spending, combined with declining revenues from FDI, pose serious challenges for



***A midwife in Philippines tending to her patient***
Photo: Eleanor Farmer / Oxfam

ASEAN countries, increasing their average budget deficits from 1.5% to 4.2% of gross domestic product (GDP), as estimated by the IMF (2020).

Allocating budgets to public services such as healthcare, education, and social protection is one of the most effective ways to fight poverty and inequality. However, most countries in the region are failing to invest sufficiently in these services. For some countries – Cambodia, Laos, Vietnam, Malaysia, and Myanmar – the situation is so critical that the Asian Development Bank has already warned that unless they mobilize significantly greater revenues in the coming years, the 2030 Sustainable Development Goals (SDGs) will not be met. Even before the COVID-19 crisis, in 2018 an estimated 73.6 million out of 653.9 million people in the ASEAN region, or 11.3% of the total, were living in poverty (VEPR et al., 2020). ASEAN countries also have high levels of economic inequality. The Philippines, Malaysia, and Singapore had Gini indices of 0.45, 0.42, and 0.40 respectively in the 2010–17 period, while the figures for Indonesia, Thailand, Cambodia, Laos, and Vietnam were, respectively, 0.39, 0.38, 0.37, 0.36, and 0.36 (Ibid.). It is estimated that already high rates of poverty and economic inequality will worsen further due to COVID-19. A recent analysis estimates that the Asia-Pacific region will see a 20% contraction in income and consumption, which will push an additional 214.1 million people below the poverty line of $5.50 a day (Sumner, Hoy, and Ortiz-Juarez, 2020).

In this context, ASEAN member countries need to come together and agree to stop the race to the bottom and improve their business environments in order to attract long-term and sustainable FDI and provide fiscal resources to deal with the pandemic. This report makes the following recommendations.

## RECOMMENDATION 1:

**AGREE UPON MEASURES TO IMPROVE THE BUSINESS ENVIRONMENT, FOCUSING ON KEY FACTORS.**

ASEAN Member States should sit down together and agree instead on a 'race to the top' by improving the elements of their business environments that have significant impacts on FDI inflows. For example, the top priorities should be economic openness, reducing the administrative burden of doing business, and human capital. In parallel with this, ASEAN countries should make efforts to enhance other indicators of the macro-economic environment and institutional quality, such as economic freedom, government effectiveness, regulatory quality, quality of infrastructure, and technological readiness. This would help them to reorient investment promotion in a more sustainable direction.

## RECOMMENDATION 2:

**STOP COMPETING TO PROVIDE LAND INCENTIVES.**

ASEAN countries need to stop competing to provide land incentives as a means of attracting FDI, due to the harm that such incentives do to local societies in terms of land conflict and disparities of income. Exemptions on rental payments should be phased out of location incentive packages. Member States should also take a cross-regional approach to the economic terms of land concessions, in particular agreeing on a maximum of 50 years for leasehold periods across the ASEAN region. Governments should also authorize rent price adjustments on a five-yearly basis instead of fixing rents for the whole of the lease period. Rather than offering land incentives, ASEAN countries need to coordinate efforts and their budgets to develop infrastructure projects such as roads and utilities, especially in industrial and economic zones, to help attract FDI.

## RECOMMENDATION 3:

**DRAW UP A RULEBOOK ON GRANTING NON-TAX INCENTIVES AND DEVELOP A TRANSPARENT AND ACCOUNTABLE REPORTING MECHANISM.**

To increase transparency and accountability in granting non-tax incentives, ASEAN countries need to develop a set of rules with clear timelines and selection criteria for recipients of each type of incentive. They should avoid granting incentives on a case-by-case basis, which can create opportunities for corrupt practices. Member States should also develop a transparent and accountable mechanism for reporting the incentives granted in order to ensure cooperation across the region. This mechanism should involve multiple stakeholders, such as civil society organizations and academic institutions.



# 1

# INTRODUCTION

1.1

# RESEARCH BACKGROUND

The ASEAN region remains an attractive destination for investors from industrialized countries. During the period 2010–18, inflows of foreign direct investment (FDI) into ASEAN increased by an average of 5.2% per year and in 2018 accounted for 11.5% of global FDI flows (ASEAN Secretariat and UNCTAD, 2019). However, despite steady growth and having attracted large amounts of FDI over recent decades, ASEAN Member States are still recording low levels of tax revenues and large budget deficits. More seriously, the COVID-19 pandemic and the contraction of economic activity globally are predicted to have negative impacts on national budgets, due to increased demand for government spending on healthcare at the same time as reduced inflows caused by the global economic slowdown, trade restrictions, and a plunge in domestic demand (Chandra, Mujahid, and Mahyassari, 2020). Budget deficits were expected to rise significantly in nine of the 10 ASEAN countries in 2020, from 1.5% of gross domestic product (GDP) to 4.2% on average (IMF, 2020).

Even before the COVID-19 pandemic, multiple factors had led to low rates of tax revenue mobilization in the region, despite robust economic growth and high levels of FDI in previous years. One of the major reasons for this is that revenue collection in these countries still depends largely on corporate income tax (CIT) revenues, and these revenues are deteriorating as countries are offering extensive incentives to investors (VEPR et al., 2020). Tax incentives have gradually become a standard policy practice in ASEAN as member countries offer a range of fiscal incentives to multinational corporations (MNCs) in order to attract investment (UNCTAD, 2020). More worryingly, ASEAN countries with similar economic characteristics tend to compete with one another instead of coordinating policies in their collective interests. The abuse of such tax incentives has seen ASEAN countries engage in a 'race to the bottom', with neighboring countries attempting to outdo each other in their attempts to attract investors from industrialized countries, leading to losses in revenue for all countries in the region. Over the past 10 years, the average effective CIT rate in ASEAN has decreased, from 25.1% in 2010 to 21.7% in 2020 (VEPR et al., 2020).

In addition to tax incentives, ASEAN countries use non-tax incentives to encourage investment, especially incentives related to land access (rent exemptions or reductions, lease extensions, commitments to site clearance, etc.). However, the use of preferential land policies should comply with investment laws and other national policies. Policy makers should also provide incentives selectively and should define the eligibility of recipients clearly so that incentives for investment projects are effective.

Both tax and non-tax incentives are widely used by ASEAN countries to attract FDI. However, the actual effectiveness of these preferential policies in promoting investment is disputed. Research has found no evidence that tax incentives have a positive effect on attracting FDI in ASEAN countries – in fact, quite the opposite (James, 2014). Most incentives of this type are granted by Member States not in order to attract long-term investment, but instead to cover weaknesses in governance and infrastructure and to meet the short-term expectations of investors. Moreover, both tax and non-tax incentives have created an unfair investment climate for domestic firms as well as for small and medium-sized enterprises (SMEs) (VEPR et al., 2020).

A country's business environment, measured by indicators such as market size and institutional quality, has more significant positive impacts on its attractiveness to foreign investors than tax and non-tax incentives. Results from a study by UNIDO (2011) on the attractiveness of different factors to foreign investors in sub-Saharan African countries showed that foreign investors were more interested in economic and political stability than in incentive packages when making decisions about where to locate their investments. Nevertheless, with the exceptions of Singapore and Brunei, ASEAN countries have performed poorly in developing an environment that is favorable for businesses to thrive.

In this context, and under the framework of the Vietnam Alliance for Tax Justice (VATJ), the Vietnam Institute for Economic and Policy Research (VEPR) has cooperated with The PRAKARSA, an Indonesian non-governmental organization (NGO), under the coordination of Oxfam in Vietnam, to evaluate the impact of business environments and non-tax incentives on capital flows of FDI into ASEAN countries.

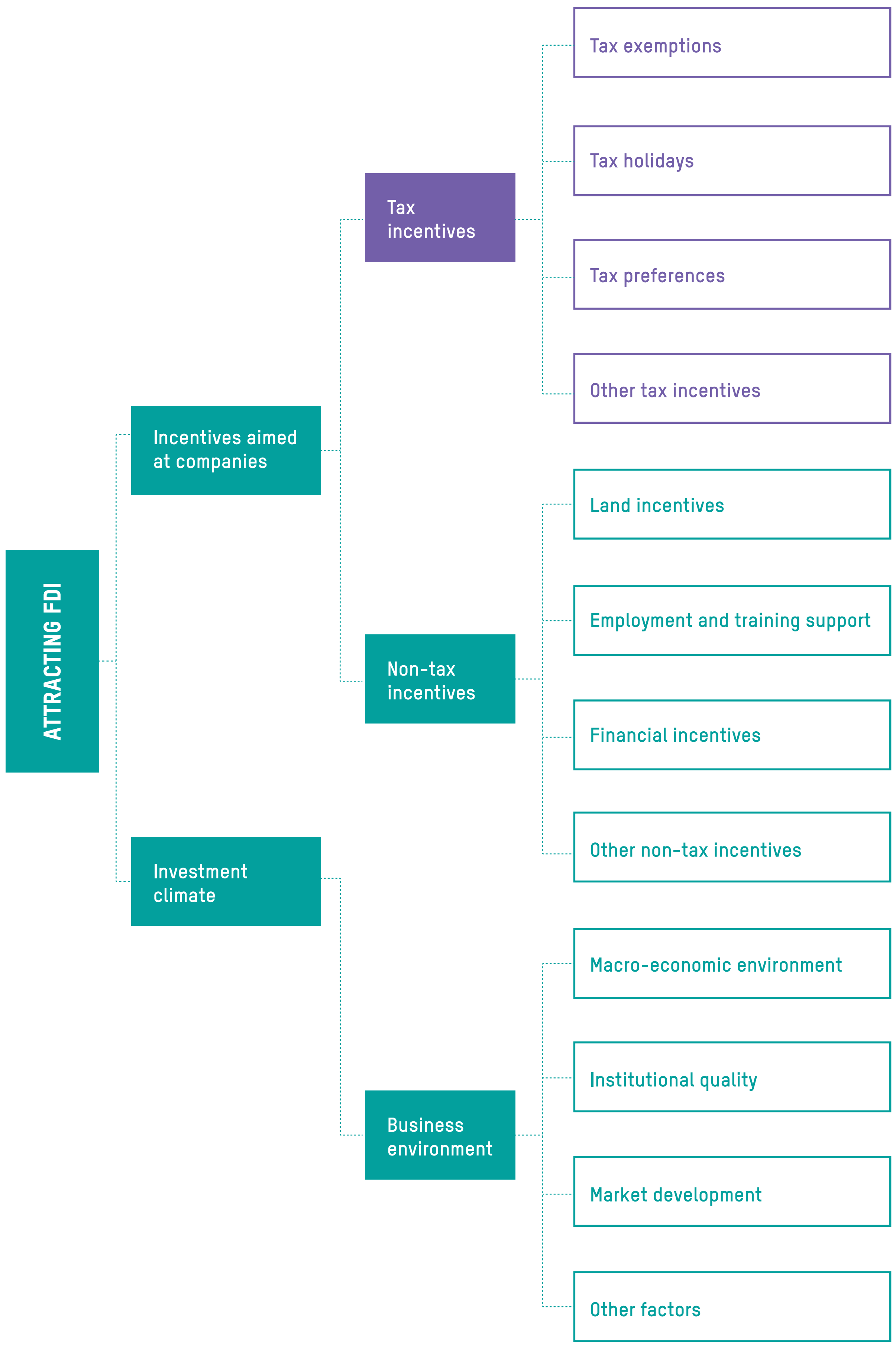
1.2

# FRAMEWORK AND DEFINITIONS

Determinants of FDI fall into two main categories: incentives targeted at foreign companies and the investment climate. Incentives targeted at foreign companies are defined as privileges provided to foreign enterprises to encourage inward investment; they take the form of both tax and non-tax incentives. Tax incentives include fiscal policies designed by a government to stimulate investment by reducing corporate taxes, such as tax exemptions, tax holidays, and tax preferences. Non-tax incentives include all incentives other than tax policies: for example, land incentives, employment and training support, and financial incentives are among the non-tax incentives widely used in ASEAN countries.

The term 'investment climate' refers to the economic, social, and political conditions in a country that affect investment decisions. This report addresses business environment drivers of the investment climate as determinants of FDI flows into ASEAN, including the macro-economic environment, institutional quality, market development, and other factors, and analyses the role of non-tax incentives in attracting FDI to the region.

FIGURE 1: THE FRAMEWORK FOR ATTRACTING FDI






## 1.3 HYPOTHESES

**In seeking to explain decisions made by MNCs on where to locate FDI projects, this report tests the following hypotheses.**

### HYPOTHESIS 1:

**INCENTIVES TARGETED AT FOREIGN COMPANIES LEAD TO A RACE TO THE BOTTOM.**

According to VEPR et al. (2020), in order to attract FDI, ASEAN countries have been competing in a race to the bottom by continuing to offer excessive tax incentives. This report focuses only on the costs of non-tax incentives used by ASEAN countries as they compete to attract FDI, and not on tax incentives.

### HYPOTHESIS 2:

**A CONDUCIVE BUSINESS ENVIRONMENT IS EFFECTIVE IN PROMOTING FDI.**

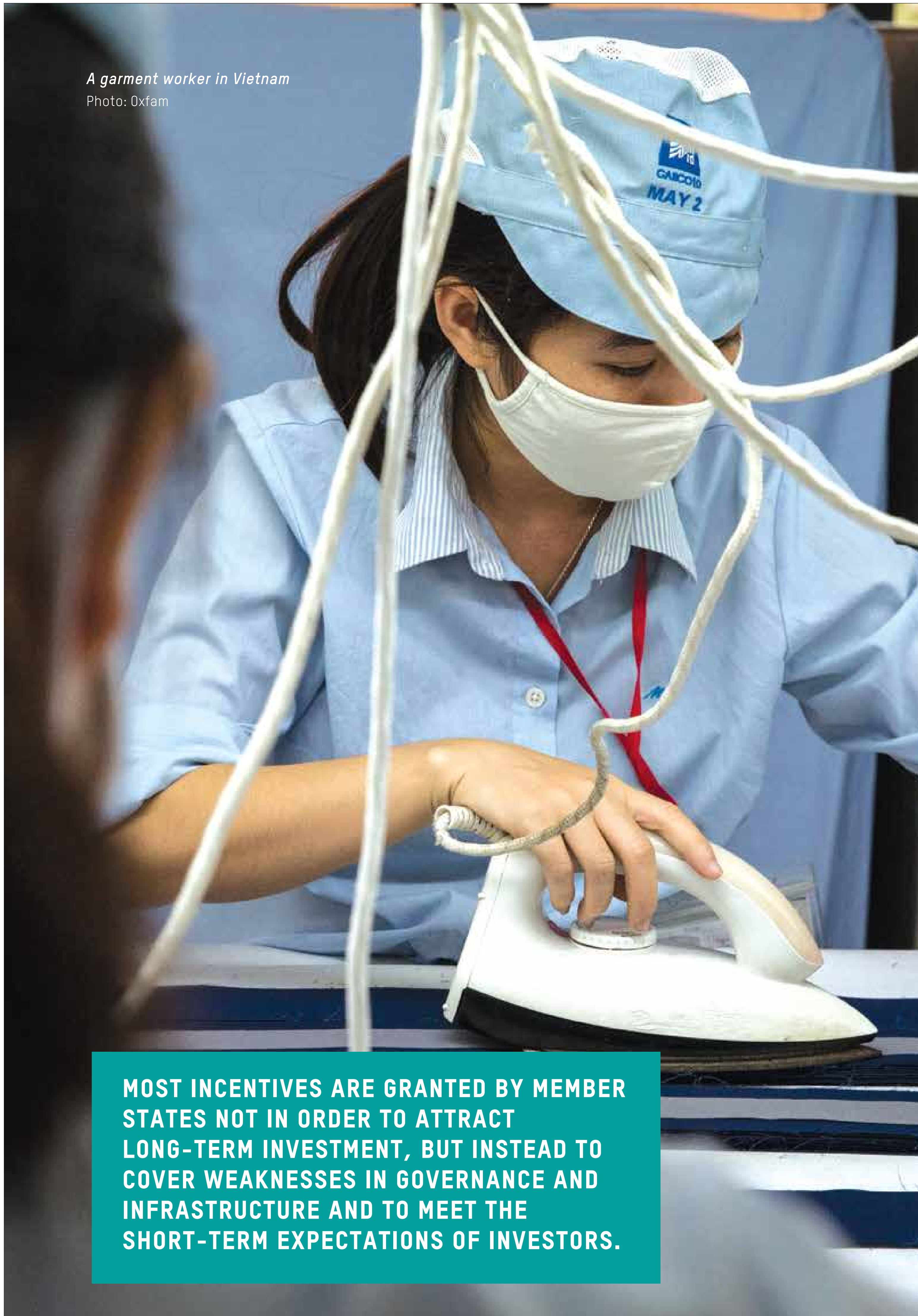
This report tests the proposition that, compared with investment incentives, which play a limited role in attracting FDI (VEPR et al., 2020), the business environment is more important to MNCs in their decision-making processes when choosing locations for their FDI.

## 1.4 RESEARCH PURPOSES AND METHODS

This study aims to clarify the impacts of the business environment and of non-tax incentives on the attractiveness of ASEAN countries for FDI, examining whether these factors play a decisive role in MNCs' investment decisions or at least have significant impacts, as might be expected. ASEAN Member States need to be aware of the 'race to the bottom' that results from the excessive provision of tax and non-tax incentives to foreign investors.

To achieve this goal, the research team set out to perform the following tasks:

- Examine FDI flows into each ASEAN country, using specific data (size of FDI inflows, country of origin, whether inside or outside ASEAN, and to which industry/sector);
- Compare the business environment in different ASEAN countries, using indicators such as the World Bank's Ease of Doing Business rankings, UNDP's Human Development Index (HDI), the Index of Economic Freedom (Heritage), the Corruption Perceptions Index (Transparency International), and other indices measuring the openness of economies, infrastructure development (ease of logistics), quality of governance, education and school systems, labor skills/quality, labor market, and so on;
- Examine current non-tax incentives such as land incentives (land rents, the terms of land lease agreements), commitments on ground clearance (clean ground) if any, and so on, to analyse the correlation between FDI inflows to each country and sector and the major characteristics of the country's investment environment other than tax incentives.




*A garment worker in Vietnam*
Photo: Oxfam

**MOST INCENTIVES ARE GRANTED BY MEMBER STATES NOT IN ORDER TO ATTRACT LONG-TERM INVESTMENT, BUT INSTEAD TO COVER WEAKNESSES IN GOVERNANCE AND INFRASTRUCTURE AND TO MEET THE SHORT-TERM EXPECTATIONS OF INVESTORS.**

# 2

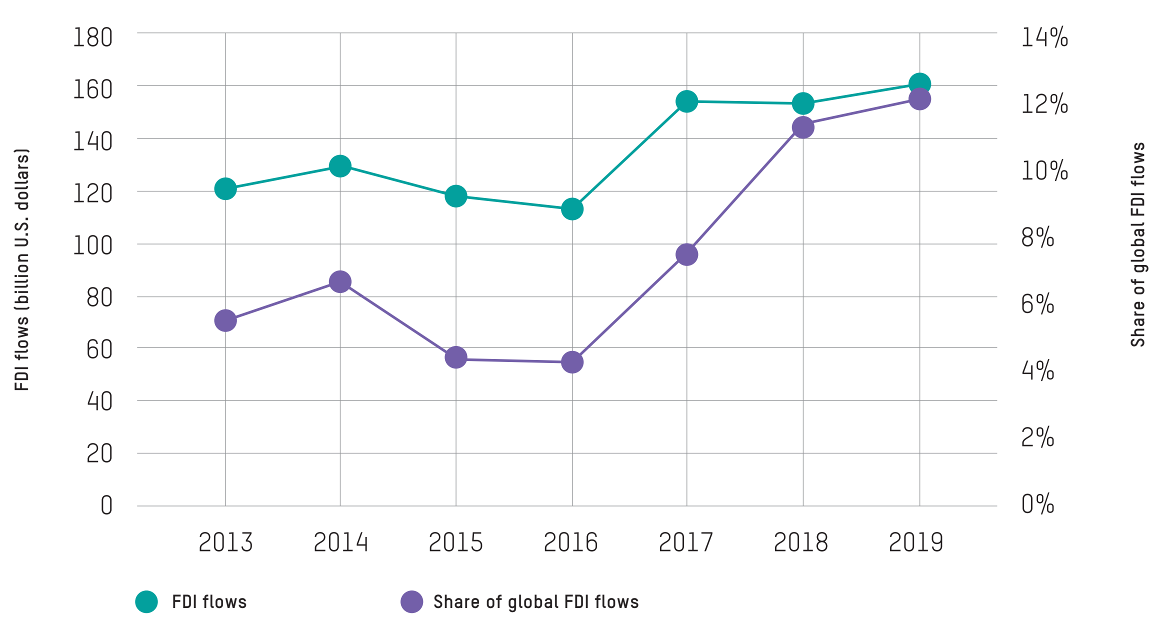
# FDI FLOWS INTO ASEAN COUNTRIES

## 2.1

# FDI FLOWS IN ASEAN

The ASEAN region witnessed a surge of 36.0% in FDI flows in 2017, after a slight drop in 2014–16. There was another slight fall in 2018 but FDI flows rose again in 2019, reaching a level of $160bn in total. In relative terms, ASEAN's share of global FDI flows grew continually from 2016 onwards, despite a slowdown in the rate of growth in 2018–19. In 2019, the region accounted for more than 12% of global FDI flows. However, the UN Conference on Trade and Development forecasts that the COVID-19 pandemic will negatively affect foreign investment decisions in ASEAN countries (UNCTAD, 2020). The main causes of this are the negative demand trends and supply chain disruptions seen as a result of trade restrictions imposed to protect domestic demand (Chandra, Mujahid, and Mahyassari, 2020). UNCTAD predicted that in 2020 the world could see a total FDI value of as low as $1 trillion for the first time since 2005 and that developing countries in Asia would see their FDI flows plunge by 30–40% (UNCTAD, 2020).

### FIGURE 2: FDI FLOWS IN ASEAN, 2013–19

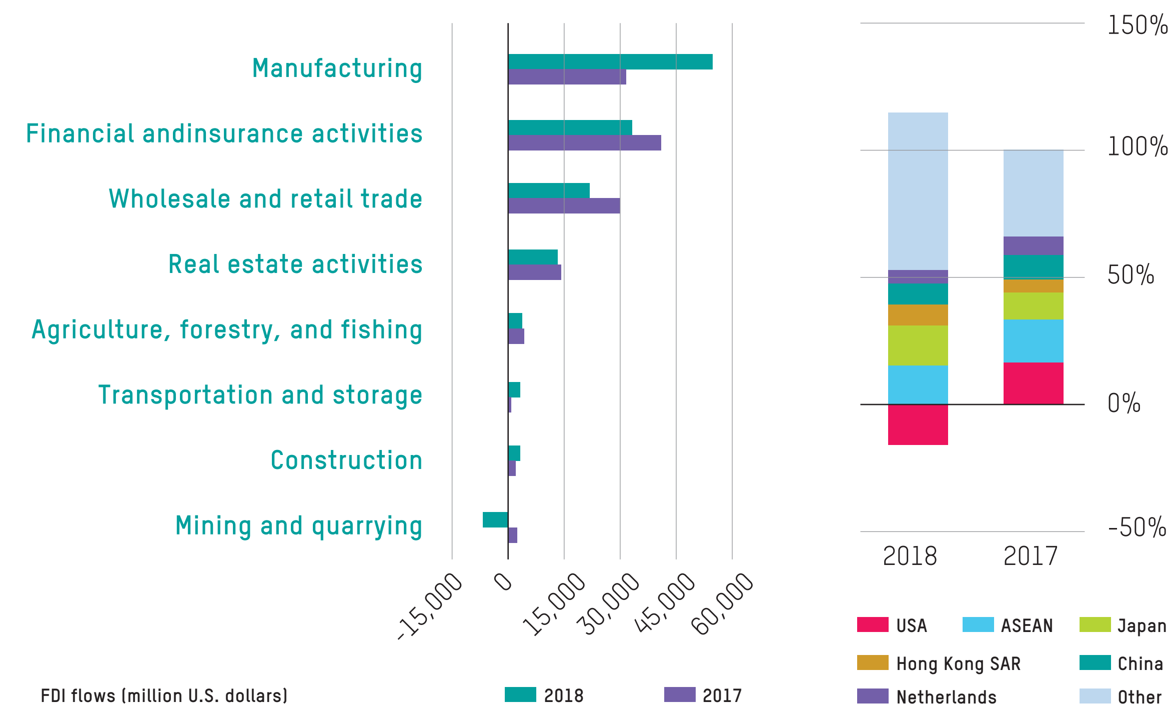



*Source: ASEANStatsDataPortal (2020) and World Bank (2020).*

An upward trend in the manufacturing sector provided one of the main engines of expansion of FDI inflows into ASEAN countries. FDI inflows in this sector rose from $31.73bn in 2017 to $54.82bn in 2018, when they represented 35.81% of FDI flows into the region. The services sector, including finance, wholesale, and retail, saw a decline in investment but remained a significant recipient of FDI (Figure 3). There was no significant change in FDI levels in the real estate sector in 2017–18, with investment in this sector accounting for 8.7%–9% of the region's FDI inflows. The amount of FDI in the agriculture, transportation and storage, and construction sectors is relatively small compared with the four largest sectors. However, these three sectors remained important to foreign investors, each claiming around 2% of total FDI flows.

The most important source of FDI in the ASEAN region is intra-ASEAN investments, which represented 16.71% of all flows in 2017 and 15.90% in 2018. The USA was a major investor in ASEAN in 2017, but FDI from this source declined significantly to -15.33% relative to total flows into ASEAN. Investors from Japan and Hong Kong SAR increased their investments in 2018, by 46.21% and 112.11% respectively, whereas investors from China and the Netherlands reduced theirs, respectively, by 20.20% and 69.23%. Many economies globally have been significantly affected by the COVID-19 pandemic, and China, the USA, and EU countries are no exception. This may indirectly influence the plans of multinationals from these countries to invest in ASEAN (OECD, 2020).

### FIGURE 3: ASEAN – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18



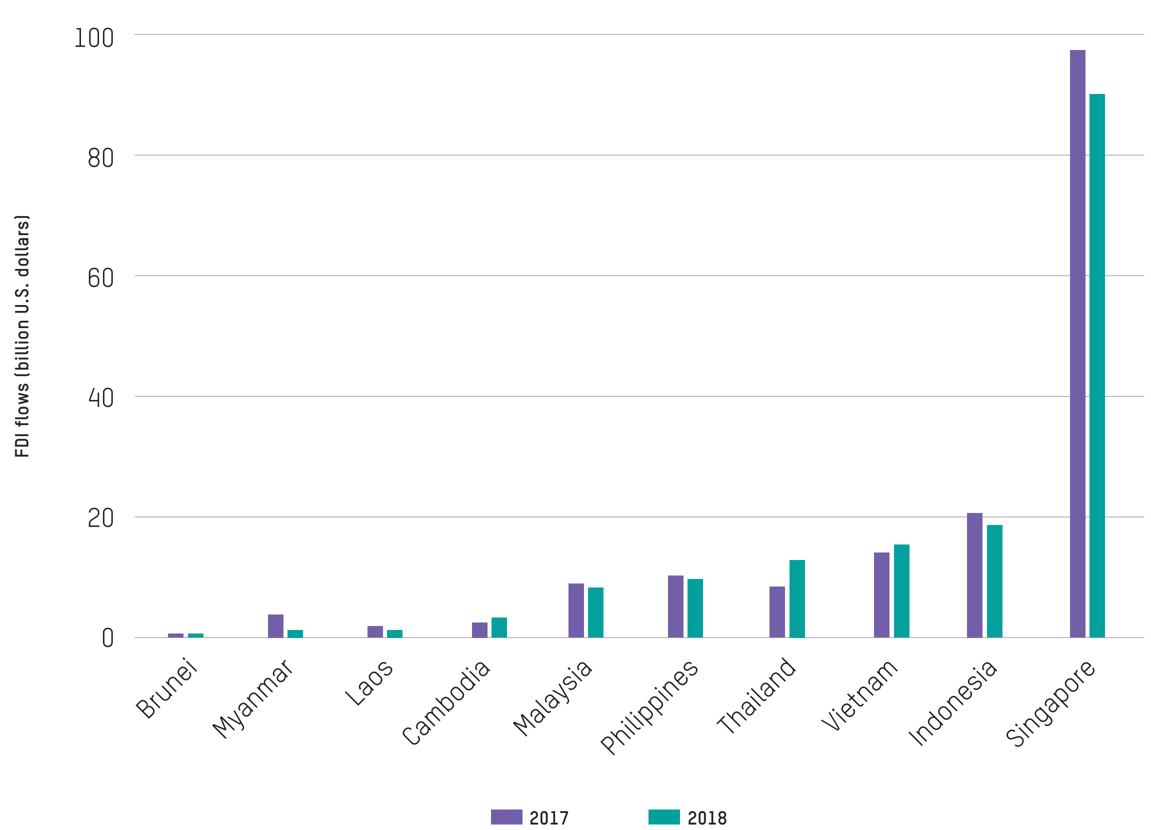

*Source: ASEANStatsDataPortal (2020).*

## 2.2

# FDI FLOWS TO INDIVIDUAL COUNTRIES

From 2017 to 2018, six of the 10 countries in the ASEAN bloc experienced a decline in FDI flows, while four saw them rise. A 60% increase in FDI inflows allowed Thailand to overtake Malaysia and the Philippines, while a fall in investment of 32% saw Myanmar attract the second lowest FDI flows in ASEAN in 2018, ahead only of Brunei.

**FIGURE 4: FDI FLOWS IN ASEAN BY COUNTRY, 2017–18**




*Source: World Bank (2020).*

Due to the differences in macro-economic factors between ASEAN countries, such as population size and economic development, a simple comparison of FDI flows between countries could be misleading. Therefore, in its analysis of FDI flows, this report categorizes the ASEAN countries into three groups based on their macro indicators. Singapore and Brunei have the smallest populations, the highest HDI scores, and the highest GDPs per capita (in terms of purchasing power parity, or PPP). Their GDP per capita figures were both over $70,000 in 2018 and ranked among the highest in the world, significantly greater than those of other countries in the region, all of which have figures of less than $30,000. Laos, Myanmar, and Cambodia have the highest poverty rates and the lowest HDI scores, which are significantly different from those of other ASEAN countries. These other countries – Malaysia, Thailand, Indonesia, the Philippines, and Vietnam – are comparable with one another at the macro-economic level (VEPR et al., 2020), and thus form a distinct group.

*Shienna Cabus and her daughter collecting water in Philippines*
Photo: Aurelie Marrier d'Unienville / Oxfam

## TABLE 1: SUMMARY OF FDI FLOWS INTO ASEAN COUNTRIES, BY INDUSTRY AND INVESTOR HOME COUNTRY AND REGION, 2017–18

| COUNTRY | TOP INDUSTRIES | | | TOP INVESTOR HOME COUNTRIES | | |
|---|---|---|---|---|---|---|
| | INDUSTRY | FDI FLOWS (US$ MILLIONS) | | INVESTOR HOME COUNTRY AND REGION | FDI FLOWS (US$ MILLIONS) | |
| | | 2017 | 2018 | | 2017 | 2018 |
| Brunei | Manufacturing | 493 | 700 | Hong Kong SAR | 465 | 655 |
| | Financial and insurance activities | -102 | 75 | Japan | 755 | 99 |
| | Construction | 481 | 19 | ASEAN | 547 | 71 |
| | Wholesale and retail trade | -13 | -29 | Netherlands | -24 | 26 |
| | Mining and quarrying | -478 | -263 | United Kingdom | -562 | -370 |
| Cambodia | Financial and insurance activities | 948 | 1,057 | China | 628 | 807 |
| | Manufacturing | 319 | 421 | ASEAN | 601 | 776 |
| | Real estate activities | 369 | 364 | Hong Kong SAR | 355 | 341 |
| | Primary | 253 | 250 | Republic of Korea | 164 | 248 |
| | Construction | 107 | 242 | Japan | 219 | 186 |
| Indonesia | Manufacturing | 9,615 | 11,338 | ASEAN | 10,190 | 11,157 |
| | Wholesale and retail trade | 4,555 | 5,262 | Japan | 3,913 | 5,679 |
| | Agriculture, hunting, and forestry | 3,614 | 3,116 | China | 1,994 | 3,398 |
| | Transportation, storage, and communication | 527 | 2,991 | Hong Kong SAR | 548 | 1,161 |
| | Mining and quarrying | -1,294 | -5,883 | USA | -2,458 | -3,936 |
| Laos | Construction | 413 | 710 | China | 1,305 | 1,043 |
| | Electricity, gas, steam, and air conditioning supply | 678 | 200 | ASEAN | 170 | 198 |
| | Primary | 391 | 197 | Japan | 68 | 53 |
| | Financial and insurance activities | 44 | 110 | Republic of Korea | 102 | 26 |
| | Manufacturing | 91 | 18 | | | |
| Malaysia | Services | 4,860 | 4,064 | USA | - | 1,616 |
| | Manufacturing | 1,465 | 3,841 | Hong Kong SAR | 1,604 | 1,583 |
| | Construction | 465 | 173 | Japan | - | 1,204 |
| | Agriculture, hunting, and forestry | 47 | 25 | China | 1,604 | - |
| | | | | Singapore | 1,418 | - |
| | | | | United Kingdom | 1,279 | - |
| Myanmar | Transportation, storage, and communication | 18 | 1,032 | ASEAN | 2,601 | 2,097 |
| | Manufacturing | 666 | 847 | China | 560 | 462 |
| | Primary | 731 | 651 | Hong Kong SAR | 160 | 355 |
| | Electricity, gas, steam, and air conditioning supply | 446 | 410 | European Union | 440 | 213 |
| | Real estate activities | 138 | 351 | Republic of Korea | -200 | 178 |
| Philippines | Manufacturing | 1,182 | 1,095 | ASEAN | 726 | 1,070 |
| | Financial and insurance activities | 141 | 454 | Hong Kong SAR | 108 | 272 |
| | Real estate activities | 248 | 294 | China | 29 | 199 |
| | Electricity, gas, steam, and air conditioning supply | 1,388 | 199 | USA | 473 | 185 |
| | Arts, entertainment, and recreation | 28 | 198 | Taiwan (ROC) | 83 | 158 |
| Singapore | Financial and insurance services | 861,257 | 927,890 | USA | 243,688 | 214,280 |
| | Wholesale and retail trade | 279,367 | 272,010 | Cayman Islands | 105,150 | 158,710 |
| | Manufacturing | 181,736 | 221,650 | British Virgin Islands | 90,555 | 95,511 |
| | Professional, scientific, and technical administrative and support services | 114,311 | 174,792 | Netherlands | 83,441 | 90,492 |
| | Real estate activities | 41,923 | 45,766 | Japan | 70,780 | 85,194 |
| Thailand | Manufacturing | 1,132 | 4,828 | Japan | 3,132 | 5,251 |
| | Financial and insurance activities | 3,375 | 4,182 | Hong Kong SAR | 971 | 2,189 |
| | Real estate activities | 1,799 | 2,257 | ASEAN | 1,814 | 1,671 |
| | Wholesale and retail trade | 994 | 1,793 | USA | -121 | 810 |
| | Construction | -35 | 247 | China | 73 | 662 |
| Vietnam | Manufacturing | 6,238 | 7,250 | Japan | 3,384 | 3,875 |
| | Real estate activities | 1,200 | 2,891 | Republic of Korea | 2,820 | 3,720 |
| | Wholesale and retail trade | 961 | 1,605 | ASEAN | 2,538 | 2,790 |
| | Professional, scientific, and technical services | 404 | 939 | China | 987 | 930 |
| | Electricity, gas, steam, and air conditioning supply | 3,290 | 711 | Hong Kong SAR | 1,269 | 620 |

*Note: No data available on FDI flows by sector/home economy in Singapore. FDI stock is used instead.*

***Sources:** Brunei Department of Economic Planning and Statistics (2020), ASEAN Secretariat and UNCTAD (2019), Bank Indonesia (2020), Department of Statistics Malaysia, Official Portal (2020), Bangko Sentral ng Pilipinas (2020), Singapore Department of Statistics (2020), Bank of Thailand (2020).*

## 2.2.1 SINGAPORE AND BRUNEI

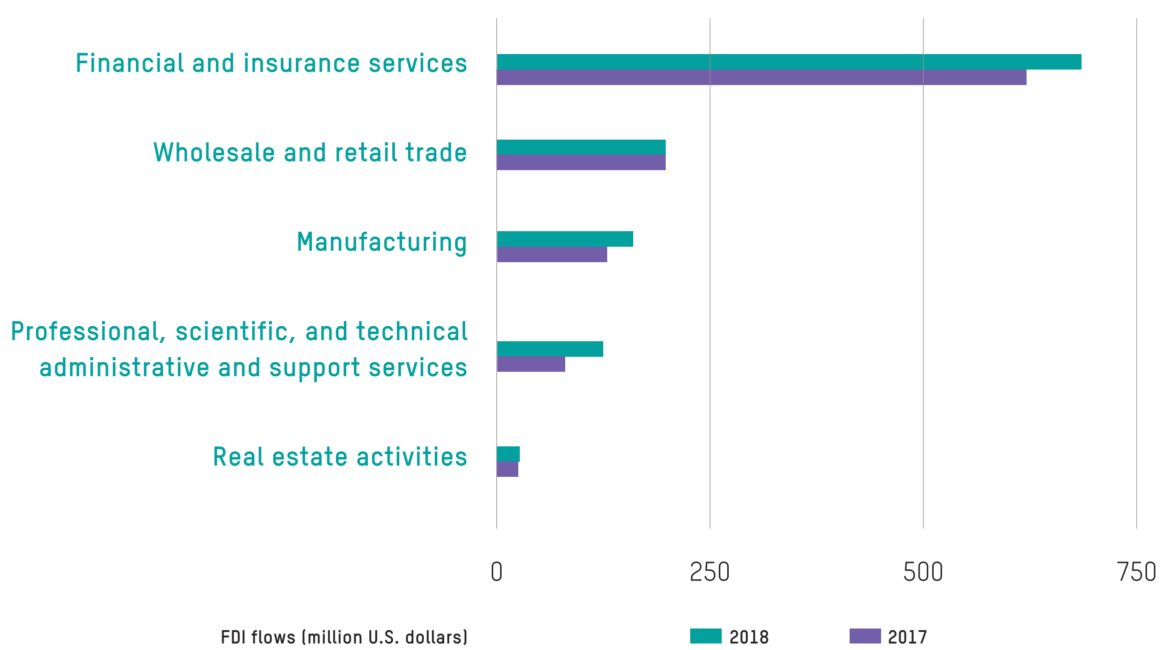
Although their macro-economic indicators are similar, Singapore is the largest recipient of FDI in the ASEAN region while Brunei is the smallest. FDI flows into both of these countries differ significantly from other countries in the bloc. There are also big differences in the pattern of investment of different industries between Singapore and Brunei. In particular, the largest recipient industry in Brunei is manufacturing, while FDI into Singapore is more concentrated in service industries such as finance and the wholesale and retail trade.

Due to the wide differences between their FDI flows and those of other ASEAN countries, Singapore and Brunei are excluded from later analyses to avoid inaccuracies caused by them being outliers.

### SINGAPORE

Financial and insurance activities help to pull the majority of FDI into Singapore, accounting for 55% of total stock in 2017 and 53% in 2018. Over this period, the wholesale and retail sector reported a slight drop in FDI stock, while levels of FDI stock rose in the manufacturing sector and three other key service industries: finance and insurance; real estate; and professional, scientific, and technical administrative and support services. The last of these in particular saw a significant increase in FDI stock, up 56.5% from $83bn to $130bn year-on-year.

**FIGURE 5: SINGAPORE – MAJOR FDI SECTORS, 2017–18**




*Source: Singapore Department of Statistics (2020).*

Of the $24bn of intra-regional investment in ASEAN in 2018, more than $15.5bn came from Singapore. The country was the region's third largest source of FDI in 2017, after only the USA and Japan. It is noteworthy that Singapore was also the largest recipient country for FDI in ASEAN, claiming more than 50% of the total. Although its FDI flows decreased between 2017 and 2018, it still had considerably greater flows compared with fellow Member States. The reason for this is that, with its generous tax incentive packages, Singapore has become the main tax haven in Asia (Damgaard and Elkjaer, 2017). The country's average ratio of FDI outflows to inflows during the 2010–19 period was 55%. According to UNCTAD (2020), much of the FDI flowing from the USA to China was channeled through Singapore. The USA was Singapore's largest source of FDI, contributing 16.64% of total inward stock in 2018. Meanwhile, China was the largest recipient of outward FDI from Singapore, accounting for 16.42% of total stock in 2018. Of the ASEAN countries, Indonesia was the largest recipient of FDI from Singapore with stock of more than $48bn, followed by Malaysia with $35.4bn and Thailand with nearly $20bn. These three countries accounted for over 83% of Singapore's outward FDI stock into ASEAN in 2018.

**FIGURE 6: TOP FIVE INVESTORS IN SINGAPORE, 2017–18**

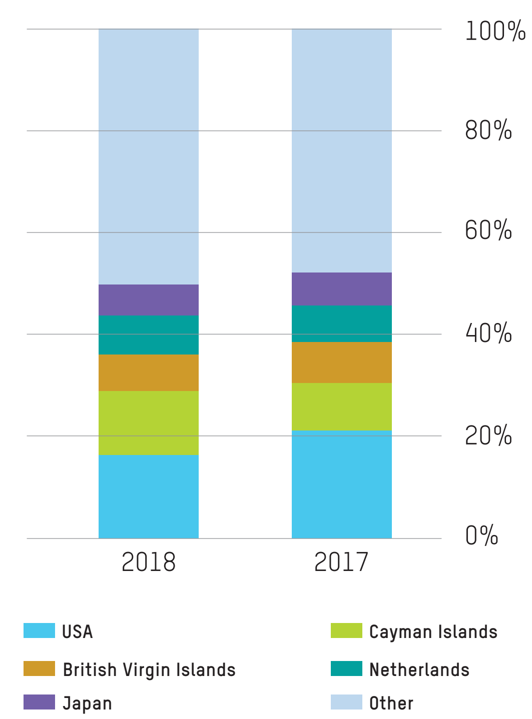
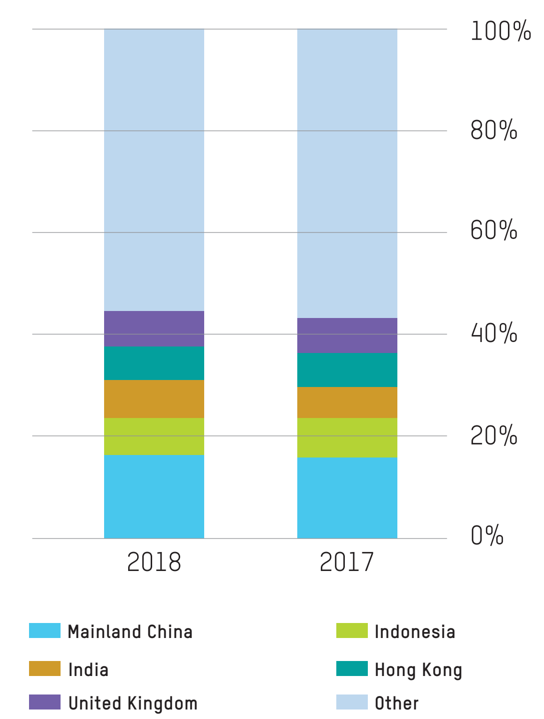


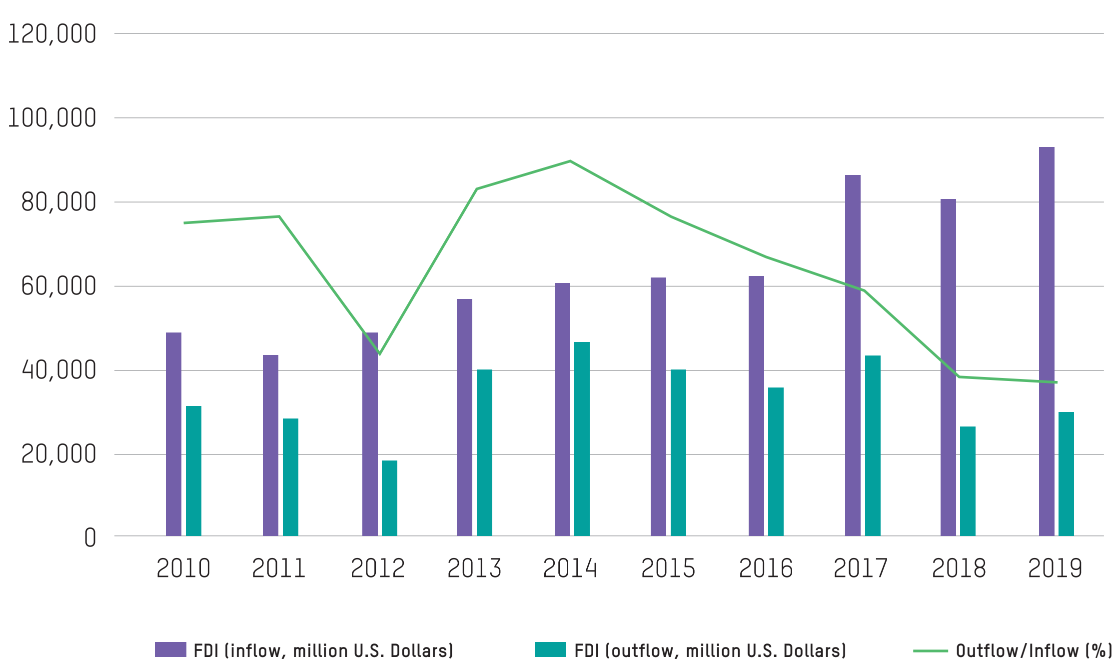

**FIGURE 7: TOP FIVE RECIPIENTS OF FDI FROM SINGAPORE, 2017–18**




*Source: Singapore Department of Statistics (2020).*

FDI inflows to Singapore have been increasing rapidly, while outward FDI (OFDI) has been fluctuating at around $30–40bn in recent years, with a decline in the outflow to inflow ratio since its peak in 2014. Singapore remains a key gateway for investment into Asia, however, and in particular attracts large amounts of 'phantom' FDI which is soon reinvested in other countries, after businesses have enjoyed the very generous tax incentives offered by Singapore. This tactic might be beneficial to Singapore as it allows it to expand its tax base, but it harms the tax bases of other countries in the region. In Singapore, generous tax benefits are often utilized by special purpose entities (SPEs) to attract FDI, and FDI financing through these vehicles is often transitory. The use of SPEs not only limits the usefulness of FDI as an indicator of real economic activity in Singapore, but also creates opportunities for tax evasion or avoidance (Damgaard and Elkjaer, 2017).

### FIGURE 8: SINGAPORE'S FDI AND OFDI, 2010–18




*Note: No data available on FDI outflow by country for Singapore.*

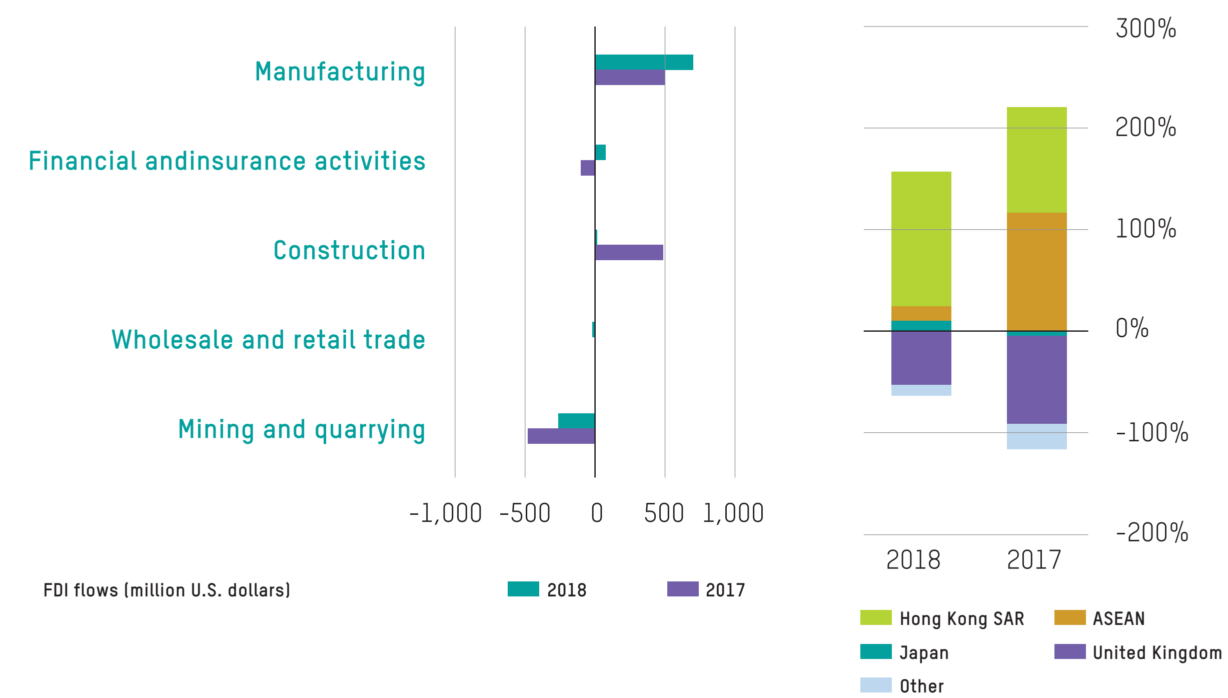
***Source: Singapore Department of Statistics (2020).***



## BRUNEI

In stark contrast to Singapore, only around 0.3% of all ASEAN FDI inflows went to Brunei in 2017–18. There were also big differences in FDI flows between Brunei and other countries in the region. The country's FDI flows increased marginally in 2017–18, mainly due to an expansion of investment in the manufacturing sector (by 42%) and an increase in inflows from Hong Kong SAR (41%). FDI in its construction sector, on the other hand, plunged by 96% to just $19m in 2018, and intra-ASEAN investments fell equally sharply by 87%, to only $71m. It was also worth noting that flows into the manufacturing sector and those from Hong Kong SAR both exceeded total flows into Brunei in 2017 and 2018, implying that negative amounts for some components made decisive contributions to the country's flows overall. In 2017 and 2018, mining and quarrying activities accounted for -103.95% and -50.87% respectively of FDI flows into Brunei, and the United Kingdom accounted for, respectively, -88.50% and -53.00%. Financial and insurance activities attracted positive flows of FDI in 2018 after one year with negative flows, and inflows from Japan also reverted to positive amounts.

### FIGURE 9: BRUNEI – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18




***Source: Brunei Department of Economic Planning and Statistics (2020).***

# 2.2.2 INDONESIA, MALAYSIA, THE PHILIPPINES, THAILAND, AND VIETNAM

In these five countries, manufacturing accounted for the majority of FDI inflows and saw an increase in 2017–18 (except for the Philippines). Primary industries in four of these five countries are not particularly attractive to foreign investors (the exception being Indonesia).

Intra-regional investments played an important role in all five countries, but there were no significant gaps between the shares of such investments and other sources in total FDI flows, except for Indonesia, where 54.26% of total FDI in 2018 came from other ASEAN countries.

## INDONESIA

Indonesia received the second highest flows of FDI in ASEAN, after Singapore, despite a slight fall in 2018. Manufacturing attracted an enormous amount of investment and accounted for around half of total flows to the country. In 2018, decreases in FDI in the primary sector (totals to mining and quarrying fell by $4.6bn and to agriculture by $0.5bn) exceeded increases in the manufacturing sector (by $1.7bn) and the services sector (FDI flows to wholesale and retail trade fell by $0.7bn and to transportation, storage, and communication by $2.5bn).

FDI from most of the primary investor home economies grew in 2018, pushing up total inflows. Around 50% of Indonesia's total inflows came from other ASEAN Member States, with intra-ASEAN investment climbing to more than $11bn in 2018. Japan and China were two other important investors, contributing respectively 27.62% and 16.53% of investment in the country in 2018. The decline in Indonesia's flows resulted mainly from a downward trend in FDI from the USA and from European countries.

### FIGURE 10: INDONESIA – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18

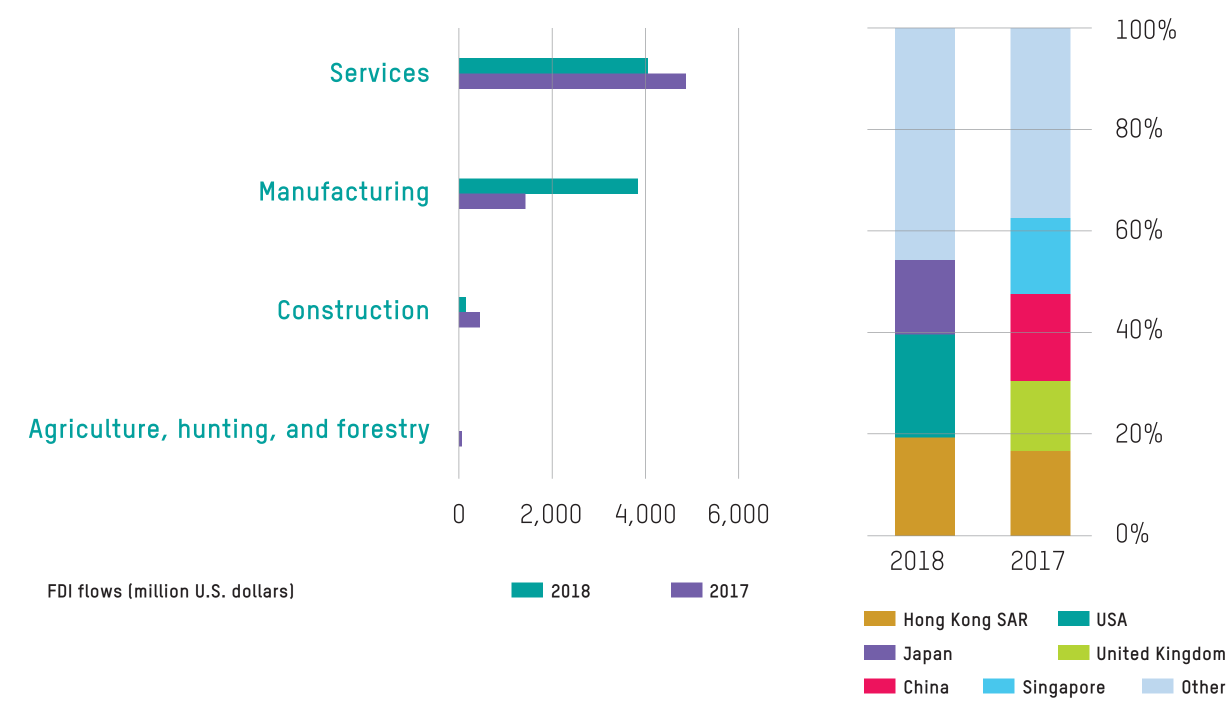

*Source: Bank Indonesia (2020).*

## MALAYSIA

FDI flows into Malaysia fell by 8.5% in 2017–18, driven primarily by a decrease in the service sector. FDI in services still played the most significant part in attracting FDI to the country, however, accounting for more than 50% of the total. The manufacturing sector showed signs of catching up with the service sector after its FDI flows rose 2.6-fold to $3.8bn in 2018. FDI in the construction and agriculture sectors was relatively insignificant, adding up to less than 6% of total flows into Malaysia and showing a downward trend.

The four biggest investors in Malaysia in 2017 were Hong Kong SAR, the UK, China, and Singapore. China and Hong Kong SAR were the two largest investors, each with 17.08% of total flows. In 2018 Hong Kong SAR continued to be one of the country's main foreign investors, along with the USA and Japan. FDI from the USA accounted for 20% of total flows, slightly higher than FDI from Hong Kong SAR, which fell marginally by 1.3% between 2019 and 2020.

### FIGURE 11: MALAYSIA – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18



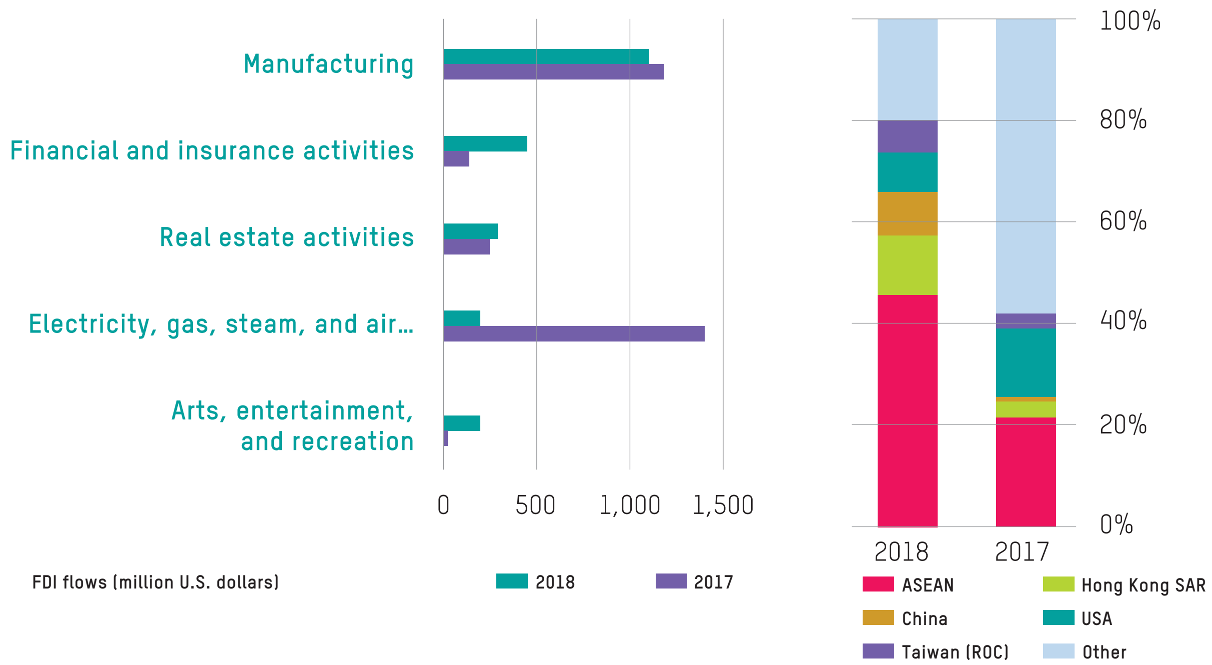

*Note: No data available on FDI flows from the USA and Japan in 2017 or from the UK, China, or Singapore in 2018.*

*Source: Department of Statistics Malaysia Official Portal (2020).*

## THE PHILIPPINES

In 2017–18 FDI flows into the Philippines remained stable at about $10bn, but there were some striking changes in their distribution. The electricity, gas, steam, and air conditioning supply sector, which was the largest recipient of FDI in 2017, suffered a sharp reduction of 86% in inflows in 2018. With the drop-off of investment in this sector, manufacturing became the biggest contributor to total FDI flows. Foreign investors also participated more actively in the services sector: FDI in finance and insurance increased by 3.2 times, while investment in the arts, entertainment, and recreation sector grew by 7.1 times.

### FIGURE 12: THE PHILIPPINES – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18




*Note: FDI flows are calculated based on net equity capital other than reinvestment of earnings.*

***Source: Bangko Sentral ng Pilipinas (2020).***

FDI flows to the Philippines depended to a great extent on investments from other ASEAN countries. Intra-ASEAN investments rose by 1.5 times in just one year, from $726m in 2017 to $1.1bn in 2018. FDI from Hong Kong SAR, China, and Taiwan also increased significantly: investment flows from Hong Kong SAR increased by 2.5 times, from China by 6.9 times, and from Taiwan by 1.9 times. Investment from the USA, by contrast, declined to $185m in 2018, accounting for just 7.87% of total flows.

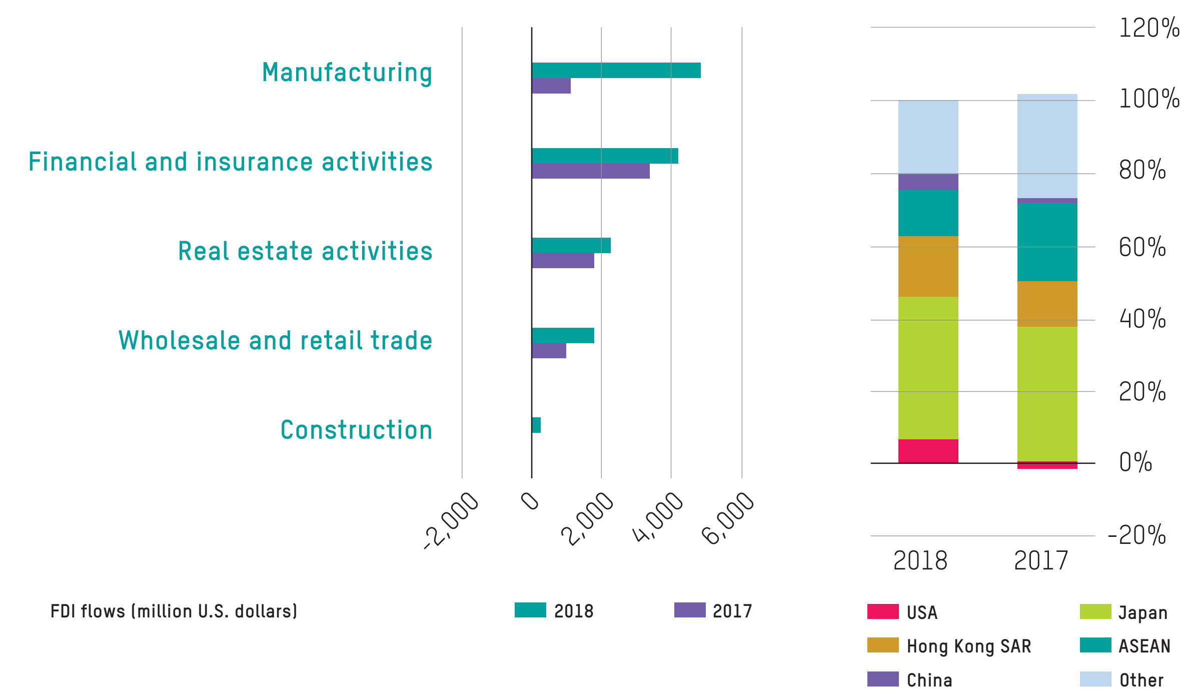


## THAILAND

Thailand made notable progress in attracting FDI in this period, expanding its share of total regional inflows from 4.86% in 2017 to 8.08% in 2018. This expansion was driven principally by an upturn in manufacturing FDI, which accounted for 36.56% of the country's total in 2018. Other sectors also saw steady increases in FDI in 2018, but there were decreases in the contribution to total flows in the finance, insurance, and real estate sectors.

Japan was the most important investor in Thailand and contributed more than one-third of total flows. Intra-regional investments, which in 2017 were Thailand's second biggest source of FDI, declined in 2018, with their share of the total falling by 50%. In contrast, FDI from the USA, Hong Kong SAR, and China rose significantly, both in its amounts and shares of FDI flows to Thailand.

### FIGURE 13: THAILAND – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18



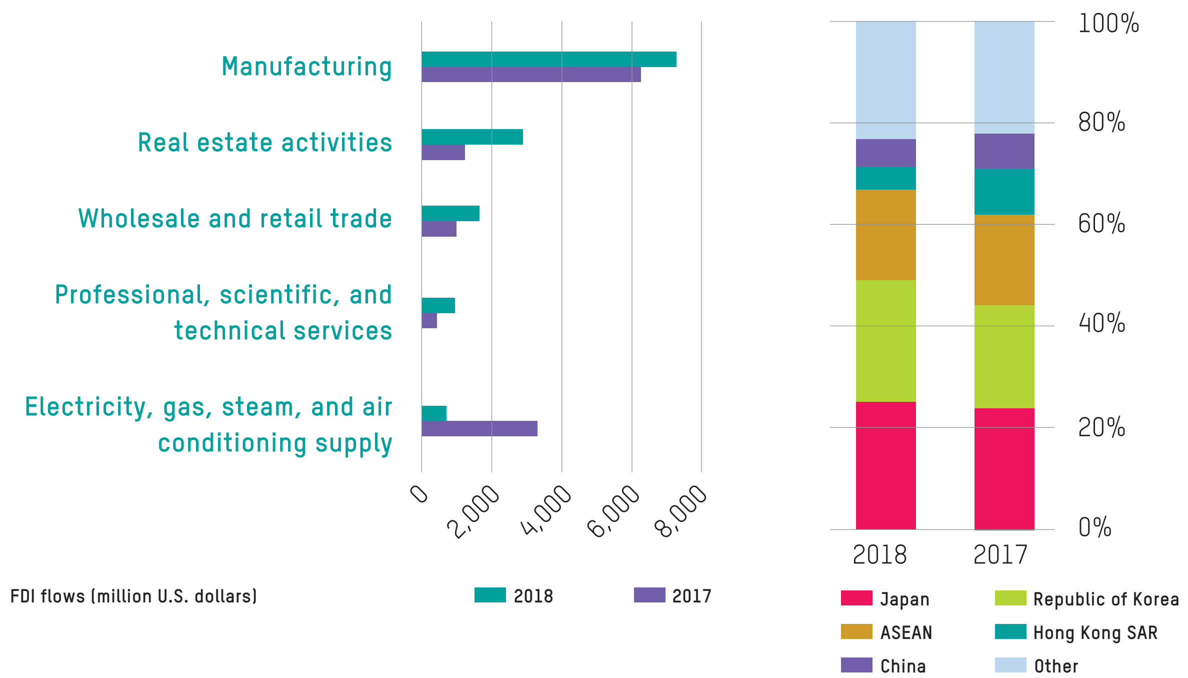

***Source: Bank of Thailand (2020).***

## VIETNAM

The striking growth of FDI in Vietnam in 2017–18 was largely due to increased investment in the manufacturing sector and some service industries. Manufacturing was the main recipient of overseas investment, accounting for 46.77% of total flows to the country in 2018. Three key service industries – real estate; wholesale and retail trade; and professional, scientific, and technical services – attracted 35.06% of total flows. FDI in the real estate sector grew by 2.4 times, in wholesale and retail by 1.7 times, and in professional, scientific, and technical services by 2.3 times, offsetting a fall of 78.39% in FDI in the electricity, gas, steam, and air conditioning supply sector.

Asian countries were the most active investors in Vietnam in 2017–18. Half of the country's FDI in 2018 came from Japan and the Republic of Korea. Investments from these countries rose by 15% and 32% respectively, contributing greatly to the expansion of total flows. Investments from other ASEAN Member States accounted for 18% of total flows in both 2017 and 2018 but saw an increase in volume from one year to the next. FDI fell from both China and Hong Kong SAR in 2018, but FDI from China declined only slightly, while that from Hong Kong fell by 50%.

### FIGURE 14: VIETNAM – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18




*Source: ASEAN Secretariat and UNCTAD (2019).*



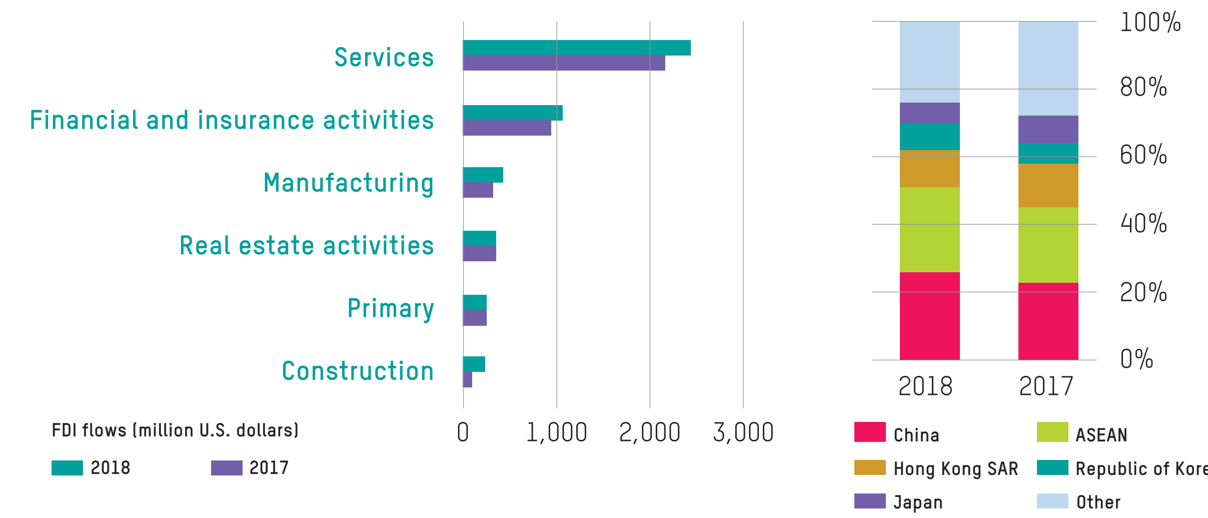
# 2.2.3 CAMBODIA, LAOS, AND MYANMAR

These three countries are the only ones in the region to have primary industries among their top five FDI recipients. Cambodia and Laos are heavily dependent on China as their biggest source of FDI. Cambodia has a more diversified investor base than Laos, where Chinese FDI accounts for 79% of total inflows. In contrast with Cambodia and Laos, Myanmar is more dependent on intra-ASEAN investments, but China is still its second largest source of FDI.

## CAMBODIA

Cambodia experienced a 15% increase in FDI flows, from $2.8bn in 2017 to $3.2bn in 2018. About one-third of its FDI was directed towards financial and insurance industry activities. Its manufacturing and real estate sectors received roughly equal amounts of FDI, together accounting for 25% of the total. Overseas investment in most industries did not change significantly over the two-year period, especially in the primary sector and real estate, where inflows were largely unchanged. The construction sector was an exception, with FDI flows doubling in 2018.

### FIGURE 15: CAMBODIA – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18




*Source: ASEAN Secretariat and UNCTAD (2019).*

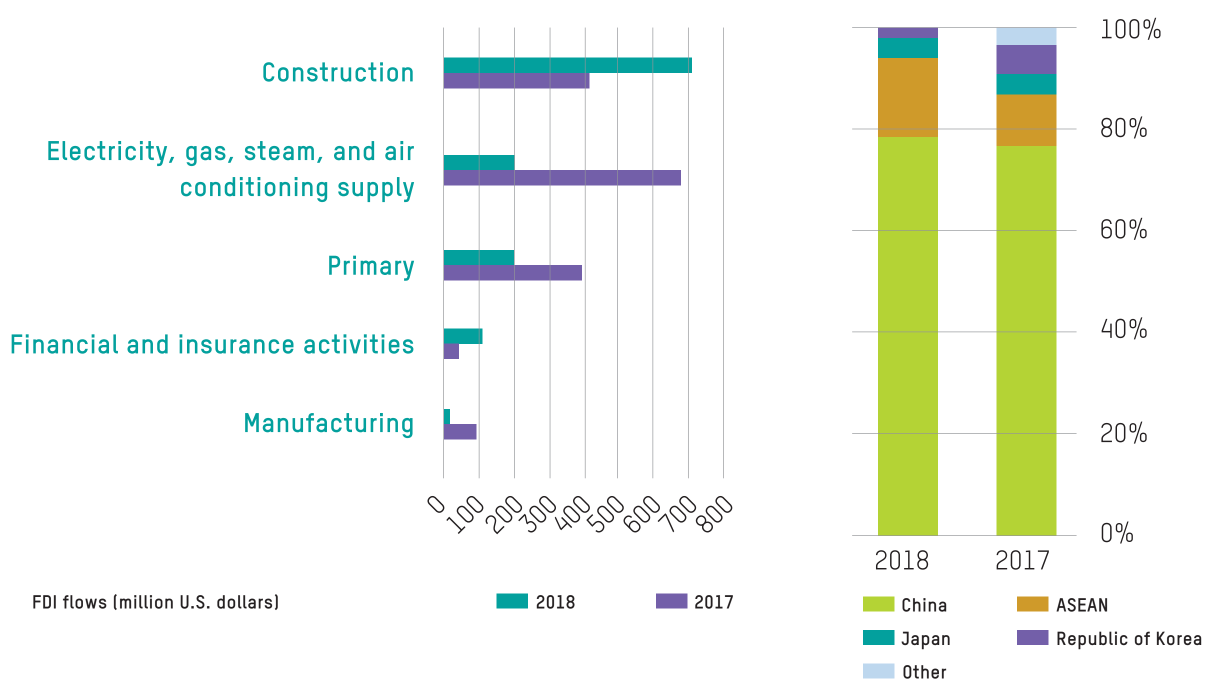
The biggest investors in Cambodia were other Asian countries, with China and other ASEAN members making up half of all FDI flows. Korean companies expanded their investment in the country from 2017 to 2018, while MNCs from Hong Kong SAR and Japan invested less.

## LAOS

In 2017 electricity, gas, steam, and air conditioning supply was the most attractive industry sector for foreign investors in Laos, accounting for 40% of its total inflows. However, in 2018 FDI in this sector declined by 70.5% and it was overtaken by construction, which saw growth of 71.9% and accounted for more than half of total FDI flows that year. Unlike most other ASEAN countries where manufacturing received a large proportion of FDI, in Laos this sector accounted for just 5.37% of flows in 2017 and 1.36% in 2018. FDI in the primary sector also fell significantly, though investment in financial and insurance activities doubled in 2018.

A major project to build the China–Lao People's Democratic Republic railway was launched in 2017 and is due for completion in 2021, and so it is not surprising that nearly 80% of FDI flows into Laos originated from China in this period, with at least 41.5% of this going into construction (UNCTAD, 2020). FDI flows from China decreased in absolute terms in 2018, but the country's share of total flows increased from 77% in 2017 to 79% in 2018. FDI flows from Japan and the Republic of Korea also fell, by 22% and 74% respectively, but Japan's share of total flows remained unchanged at 4%, while Korea's share decreased from 6% to 2%. Meanwhile, intra-ASEAN investments rose by 17% and contributed 15% of total flows in 2018.

**FIGURE 16: LAOS – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18**




*Source: ASEAN Secretariat and UNCTAD (2019).*

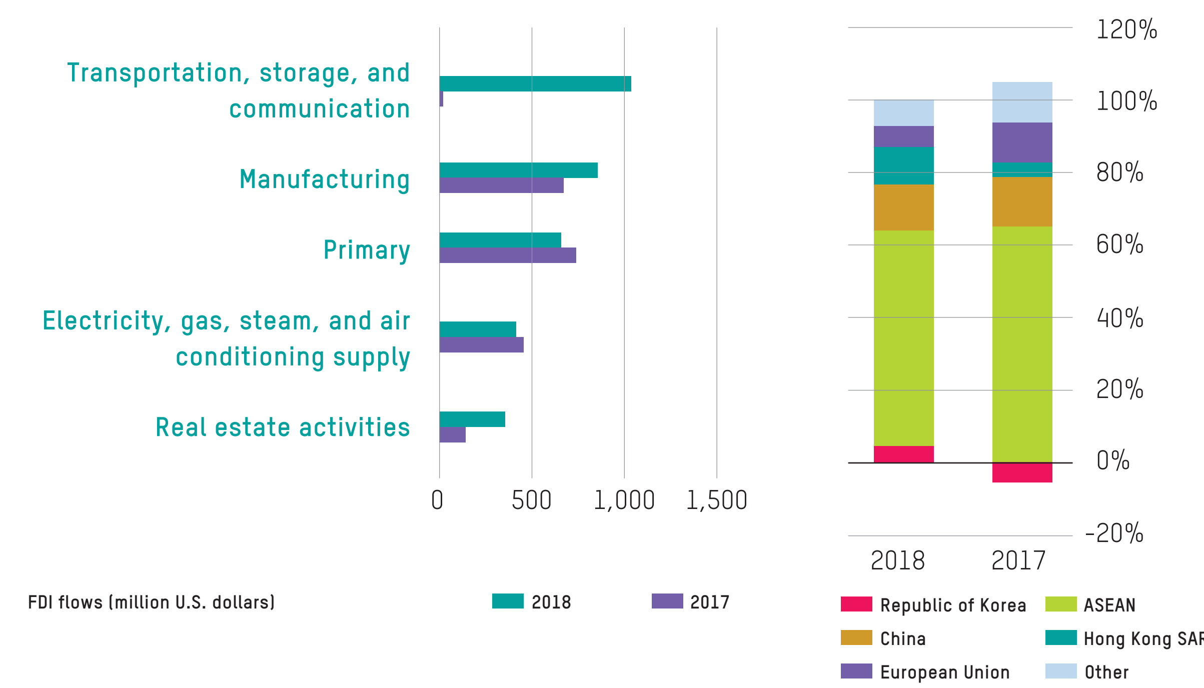


## MYANMAR

Despite a significant decline in 2018, Myanmar's FDI inflows remained relatively high and continued to show potential in all three main sectors (primary, manufacturing, and services). The infrastructure sector experienced the most impressive expansion of FDI in 2018, with flows increasing from just $18m in 2017 to $1bn. There were also bright spots in the manufacturing and real estate sectors. FDI in the primary sector and in the electricity, gas, steam, and air conditioning industry fell slightly, but stayed at high levels overall.

The primary source of FDI in Myanmar was intra-regional investment, which represented 65% of total flows in 2017 and 59% in 2018, though falling by more than $500m from one year to the next. FDI from China and the European Union also decreased in both absolute and relative terms. However, companies from Hong Kong SAR more than doubled their investments in Myanmar, and FDI flows from the Republic of Korea reversed from -$200m to $178m.

**FIGURE 17: MYANMAR – MAJOR FDI SECTORS AND INVESTOR HOME COUNTRIES AND REGIONS, 2017–18**



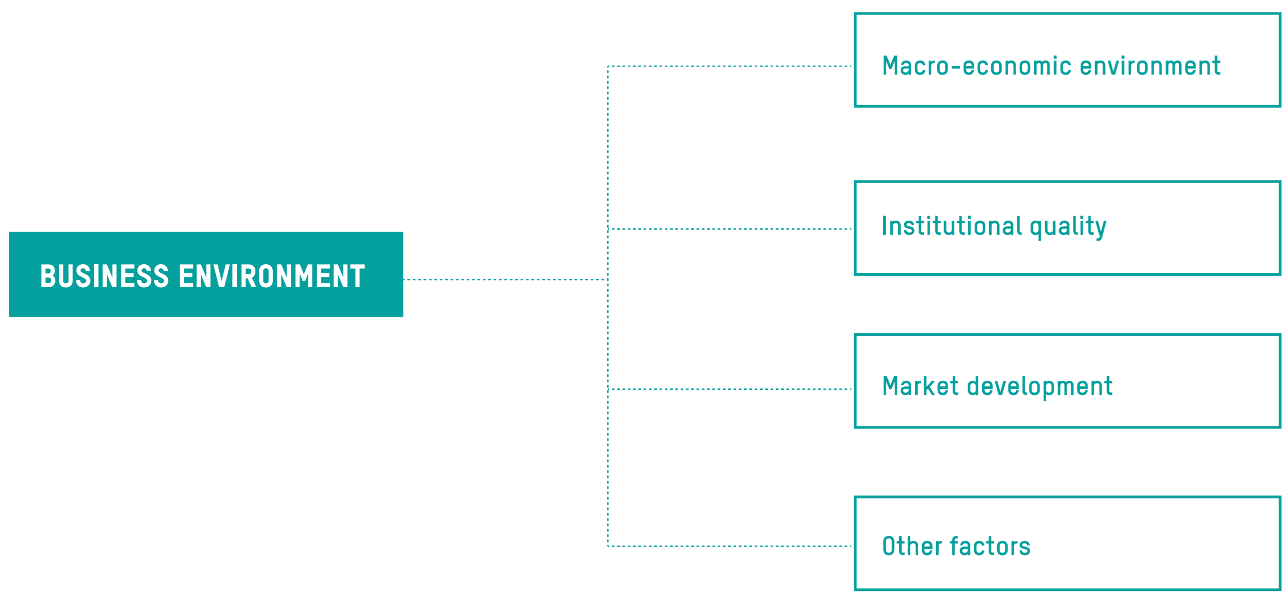

*Source: ASEAN Secretariat and UNCTAD (2019).*

*Smallholder farmers' livelihoods*
Photo: Kimlong Meng / Oxfam

# 3 BUSINESS ENVIRONMENT AND FDI FLOWS IN ASEAN COUNTRIES

The business environment is a key determinant in choices made by MNCs about locating FDI in developing countries. In ASEAN countries business environments differ markedly in factors such as economic freedom, ease of doing business, governance quality, infrastructure, and labor quality.

**FIGURE 18: COMPONENTS OF THE BUSINESS ENVIRONMENT**




Singapore is a long way ahead of other ASEAN countries in creating an ideal environment for business. It is ranked first in ASEAN as well as in the world for many factors, including economic freedom, government effectiveness, economic openness, investment environment, and higher education and training. Singapore also leads the region in all aspects other than macro-economic environment and market size, in which it consistently underperforms.

The business environment in Brunei is also highly favorable, with a well educated and healthy population, well developed infrastructure, and advanced technology. Brunei ranks second in the region, after only Singapore, in particular in terms of drivers of quality of governance, such as government effectiveness, regulatory quality, and perceptions of corruption. However, the country needs more practical action to boost the development of its markets. In 2018, it ranked last among ASEAN countries on market-related aspects such as market size and development of financial markets.

Since both Singapore and Brunei are very different from other ASEAN countries in terms of FDI flows and their business environments, these two countries are excluded from the analysis below in order to avoid skewing the findings.



## 3.1 LITERATURE REVIEW

Empirical evidence from previous studies suggests that attracting FDI is sensitive to certain indicators of the business environment. Aspects of the business environment such as macro-economic environment, institutional quality, and market development have been found to significantly influence FDI decisions.

Macro-economic factors such as the inflation rate, economic freedom, and trade liberalization also have statistically significant relationships with FDI flows. The rate of inflation, as an indicator of economic stability, appears to be negatively correlated with FDI flows (Demirhan and Masca, 2008). Economic freedom is identified as the most important determinant of FDI (Ghazalian and Amponsem, 2019). Trade liberalization, often referred to as a component of economic openness, is a key element of policy reforms that aim to attract FDI. According to the OECD (2019), the inverse relationship between its FDI Regulatory Restrictiveness Index[1] and inward FDI stock indicates that a country with a highly restrictive business environment tends to attract less FDI. Notably, evidence from Malaysia, Indonesia, Vietnam, and the Philippines shows that foreign investors are likely to respond positively to major regulatory reforms that promote liberalization. However, it is noted that rapid liberalization of services can hurt domestic service providers and intensify poverty and inequality in developing countries. Indeed, the Philippines, Indonesia, Malaysia, and Vietnam, all of which have undergone major liberalization reforms, recorded alarming inequalities of wealth during the 2010–17 period, with Gini index scores of 0.84, 0.84, 0.82, and 0.74 respectively (VATJ, 2020). Therefore, in designing trade liberalization policies, governments need to take into consideration the potential threats posed by such liberalization to vulnerable groups and implement policies, if necessary, to address the negative effects on poverty and inequality (McCulloch et al., 2001).

Studies on the impact that institutional quality has on FDI point out that poor governance is a critical factor leading to low levels of inflows. Poor-quality governance in a host country can increase costs for investors, stemming from corruption, ineffective government, and poor enforcement of intellectual property rights (IPR). Wei (2000) argues that corruption is a deterrent to foreign investment, while Kaufman et al. (1999) find that political instability and violence, the effectiveness of government, the regulatory burden, the rule of law, and graft and corruption all have significant impacts on FDI flows. To this list, Bénassy-Quéré, Coupet, and Mayer (2007) add information, the banking sector, ease of market entry, and legal institutions as factors that can have significant and positive impacts on the amount of FDI received.

Many ASEAN countries have been aware of the importance of protecting IPR in their efforts to attract FDI. Adams (2010) argues

(1) The OECD FDI Regulatory Restrictiveness Index (FDI Index) measures the restrictiveness of FDI rules in 22 economic sectors and covers 69 countries, including all OECD and G20 countries. See: https://www.oecd.org/investment/fdiindex.htm

that the positive correlation between the two is statistically significant. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), which came into effect in 1995, successfully strengthened IPR in most developing countries and thus boosted their FDI inflows. However, the TRIPS agreement has also led to concerns about poverty and inequality in developing countries as IPR protection can lead to higher prices for goods and services as companies are given rights to monopolize the use of their innovations. For instance, in the area of medicines the TRIPS agreement could potentially lead to higher costs of healthcare in developing countries, adversely affecting access to medicines for vulnerable groups (Oxfam International, 2002).

Yi and Naghavi (2017) also find a negative impact of IPR protection on welfare in developing countries, even though its purpose is to attract FDI and encourage domestic innovation. Their analysis highlights a dilemma faced by developing countries in choosing between promoting FDI and capitalizing on opportunities for technological spillover between countries. A strict IPR policy can deter the diffusion of technology by making imitation illegal. The optimal level of IPR protection, therefore, varies according to the level of technology involved, with more developed countries requiring tighter IPR enforcement. If IPR protection is regulated beyond the optimal level, however, it may well harm the economy (Yi and Naghavi, 2017). Accordingly, each country should design IPR policies, such as copyright terms, patent laws, and exceptions, based on its economic and technological environment. Yi and Naghavi (2017) also propose that developing countries should stimulate domestic innovation in order to close gaps in technology before they tighten IPR protection.

Efforts to boost market development may also help ASEAN countries to attract more FDI. A study by Hoang and Bui (2015) indicates that the size of the internal market, as represented by GDP, is one of the main factors encouraging FDI inflows into ASEAN countries. However, they show that small countries can also attract FDI through measures such as improving their institutional quality and political stability, eliminating trade barriers with their neighbors, and developing cross-border infrastructure. Findings by Soumaré and Tchana Tchana (2015) suggest a two-way causality between the development of local stock markets and the amount of FDI a country receives. A developed stock market indicates vitality, a business-friendly environment, and openness to foreign investors. However, the banking sector, as another indicator of financial markets, has an ambiguous relationship with FDI inflows (Soumaré and Tchana Tchana, 2015). The efficiency of labor markets, according to Parcon (2008), has a non-linear relationship with choices of location for investment. Flexible hiring and firing standards reduce firms' costs of adjusting labor demand according to economic situations, which encourages FDI, but a lax labor market lowers labor productivity, which discourages FDI.

Countries with high-quality infrastructure are at an advantage when it comes to attracting FDI. Goodspeed, Martinez-Vazquez, and Zhang (2011) point to a positive relationship between infrastructure quality rankings and FDI inflows, implying that inward investment is sensitive to the quality of infrastructure in the host nation, in both developed and developing countries. Gopalan, Rajan, and Duong (2019) highlight the importance of infrastructure development in attracting greenfield FDI into China and the ASEAN bloc. Their fixed-effect model also reveals that, of infrastructure variables, the total length of paved roads turns out to be the key contributor to attracting greenfield investments. A high density of roads helps to reduce the costs of transport, which benefits foreign investors, especially those in the manufacturing sector.

With the increasing involvement of technology in production processes, technological capability can be a significant factor in attracting FDI. Palit and Nawani (2007) claim that levels of domestic technological development explain why Hong Kong, Singapore, South Korea, and China continue to be attractive destinations for investment, while some ASEAN countries, such as Indonesia, Malaysia, Thailand, and the Philippines, are left behind. China and the Asian Tigers have maintained comparative advantages in attracting technology-intensive FDI by continually developing their domestic technological capabilities (Palit and Nawani, 2007).

ASEAN governments can potentially encourage foreign investment by enhancing the labor skills and productivity of their workforce. Evidence from six ASEAN countries (Vietnam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand) shows that human capital and labor productivity are positively associated with FDI inflows. Importantly, nominal labor costs also have a positive relationship with the amount of FDI a country attracts, implying that in determining the location of investments foreign investors are more interested in high labor quality than in low labor costs (Hoang, 2012). Thus, support for labor quality can become a strong incentive for FDI in ASEAN countries.

***Worker in a shrimp-processing factory in Vietnam***
Photo: Oxfam

## 3.2 BUSINESS ENVIRONMENT AND FDI FLOWS IN ASEAN COUNTRIES

Overall, ASEAN countries need to make greater efforts to enhance their business environments. Indonesia, Malaysia, Thailand, the Philippines, and Vietnam possess more favorable conditions for business than do Cambodia, Laos, and Myanmar, where many aspects of the business environment rank poorly, both within the region and internationally.

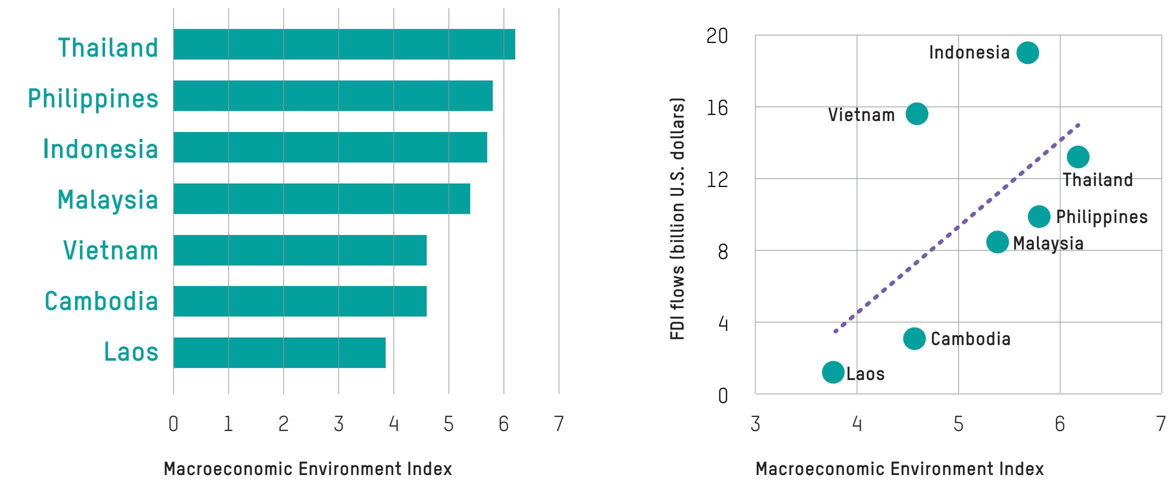
In ASEAN countries, most aspects of the business environment appear to be positively correlated with FDI inflows. In other words, conducive conditions for business growth can be associated with larger amounts of FDI. However, only economic openness, ease of doing business, market size, and human development appear to be strongly associated with FDI flows. Three aspects – IPR protection, development of financial markets, and labor market efficiency – appear to show very weak or no association with FDI flows. The following sections discuss in detail important aspects of the business environment in ASEAN countries and their relationships with FDI flows.

### 3.2.1 MACRO-ECONOMIC ENVIRONMENT

#### THE MACRO-ECONOMIC ENVIRONMENT

As indicated in Figure 19, some ASEAN countries, such as Indonesia, may benefit from having a solid macro-economic context when it comes to attracting FDI. On the other hand, countries with less favorable macro-economic environments, such as Laos and Cambodia, are lagging behind. However, the correlation between macro-economic environment and FDI flows is not very strong. Thailand leads the ASEAN bloc in the World Economic Forum (WEF)'s macro-economic environment index, but its FDI flows are lower than those of Vietnam, which has a comparably less favorable macro-economic environment.

**FIGURE 19: MACRO-ECONOMIC ENVIRONMENT INDEX, 2018**




*Note: No data available for Myanmar. The macro-economic environment is graded on a scale of 1 to 7 (1 = low, 7 = high).*

***Source: WEF (2017).***

#### ECONOMIC FREEDOM

Differences in economic freedom between ASEAN countries are not wide, as measured by Heritage's Index of Economic Freedom. As shown in Figure 20, freer economies tend to attract higher FDI inflows, but the relationship is not robust. There are a few exceptions, including Vietnam, which has the most restricted economy but receives more FDI than freer economies such as Thailand and the Philippines.

**FIGURE 20: INDEX OF ECONOMIC FREEDOM, 2018**

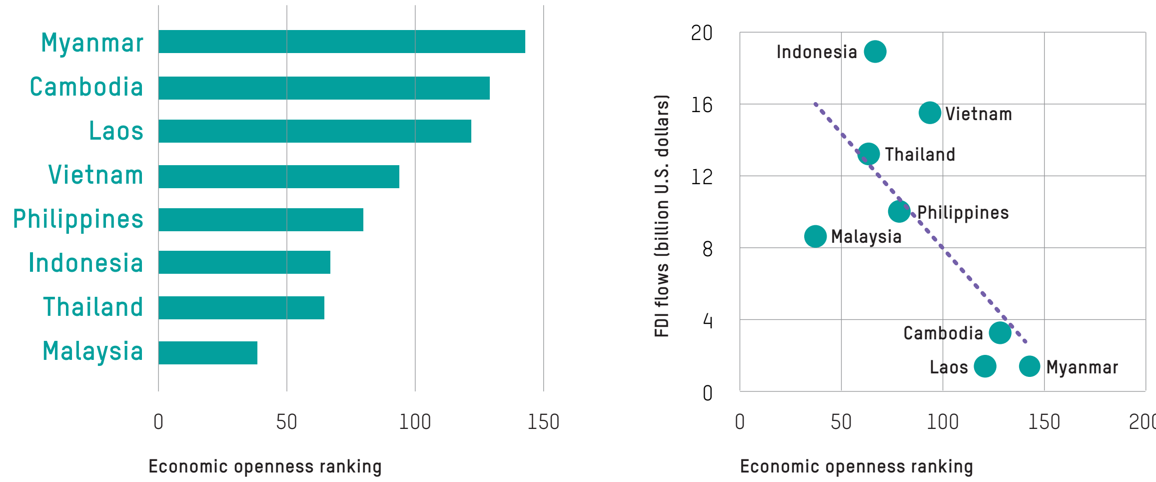

*Note: Economic freedom is graded on a scale of 0 to 100 (0 = restricted, 100 = free).*

***Source: Heritage (2020).***

## ECONOMIC OPENNESS AND INVESTMENT ENVIRONMENT

Countries' global rankings for economic openness are determined essentially by their investment environments. Malaysia and Thailand offer the most conducive investment environments in the region, and are also the most open economies. Meanwhile, the CLMV countries (Cambodia, Laos, Myanmar, Vietnam) score poorly on investment environment, which drags down their scores for economic openness. Most notably, Myanmar's investment environment ranks second lowest out of a total of 157 countries in the Legatum Institute's Global Index of Economic Openness, suggesting that substantial improvements are needed if the country is to move up the rankings for investment environment as well as economic openness.

### FIGURE 21: GLOBAL INDEX OF ECONOMIC OPENNESS, 2018



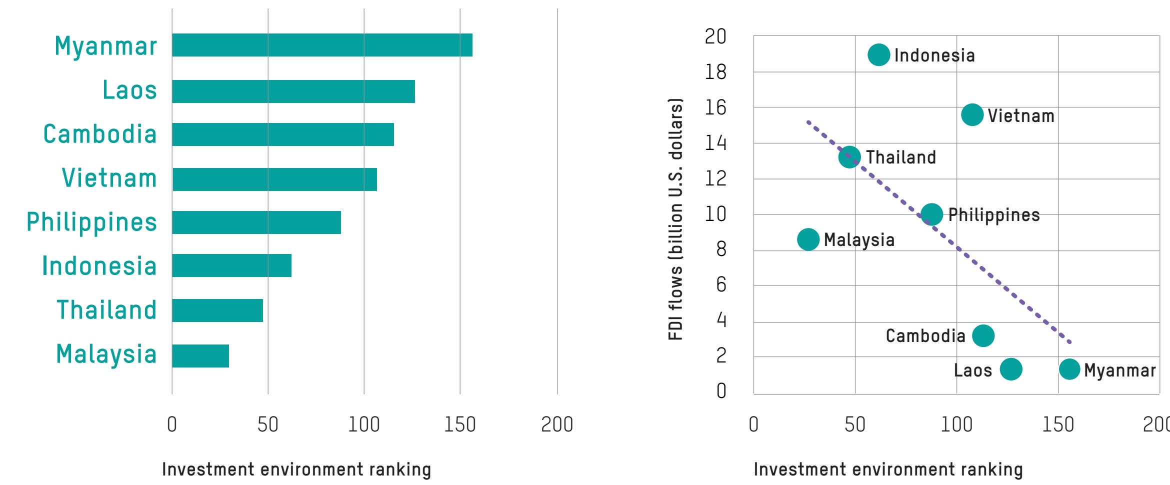

*Note: The Legatum Institute ranks economic openness in 157 countries based on four factors: market access and infrastructure; investment environment; enterprise conditions; and governance.*

***Source: Legatum Institute (2019).***

FDI flows appear to have a positive correlation with economic openness and investment environment. An ideal investment environment, often resulting in an open economy, tends to be associated with high FDI inflows. Malaysia is an exception to this rule, attracting low FDI flows despite having a very open economy and a favorable investment environment. Two groupings are apparent in the scatter plot in Figure 22, one made up of the five countries that have conducive investment environments, open economies, and high FDI flows, and the other consisting of those that do not.



### FIGURE 22: INVESTMENT ENVIRONMENT RANKINGS, 2018




*Note: The Legatum Institute's Global Index of Economic Openness ranks the investment environment in 157 countries based on property rights; protection for investors; contract enforcement; the financing ecosystem; and restrictions on international investment.*

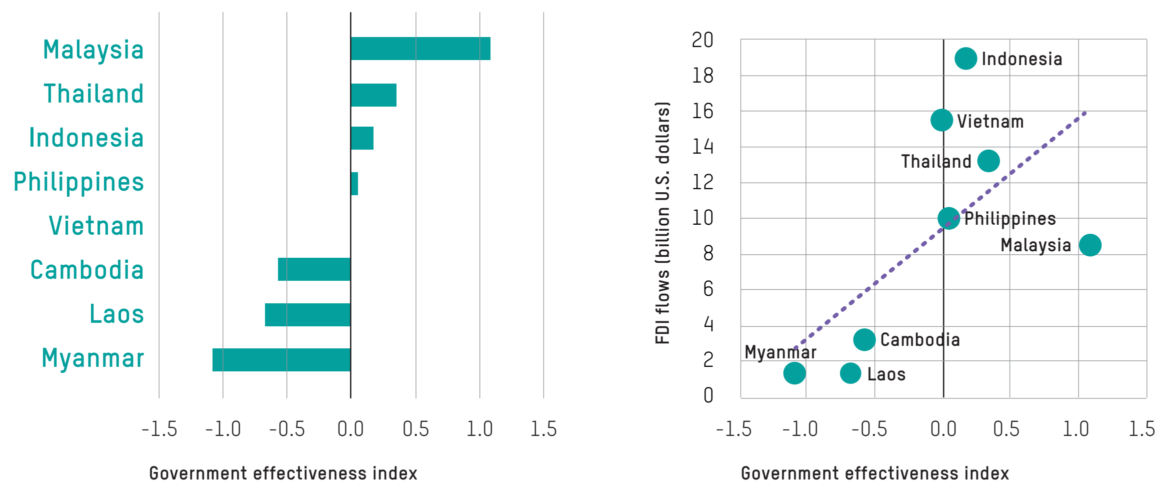
***Source: Legatum Institute (2019).***

# 3.2.2 INSTITUTIONAL QUALITY

## GOVERNMENT EFFECTIVENESS

The effectiveness of governments varies widely across the region, with that of Malaysia being the world's most effective while that of Myanmar is less effective than 87.5% of governments globally, according to the World Bank's World Development Indicators. Of the eight ASEAN countries analysed here, four have positive scores for government effectiveness, while Cambodia, Laos, and Myanmar have negative scores. There is a positive relationship between government effectiveness and FDI flows. Myanmar, for example, is behind most countries in the region in terms of both government effectiveness and FDI flows. The vertical axis in Figure 23 divides the countries into two distinct groups. A group of five countries that have more effective government and also attract higher FDI flows lie to the right of the axis, while the other three are on the left.

**FIGURE 23: GOVERNMENT EFFECTIVENESS INDEX, 2018**



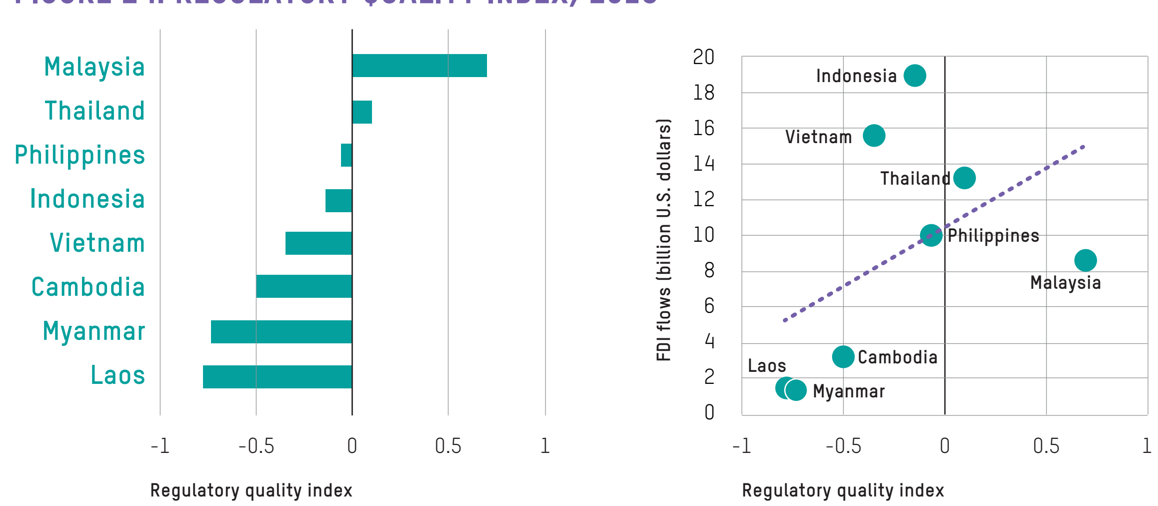

*Note: Scores for government effectiveness are taken from the World Bank's World Development Indicators. Government effectiveness is graded on a scale of -2.5 to 2.5 (-2.5 = low, 2.5 = high).*

***Source: World Bank (2020).***

## REGULATORY QUALITY

Indicators for regulatory quality capture the ability of governments to support the development of the private sector through the regulations they introduce. Six of nine countries in the ASEAN bloc received negative scores for regulatory quality in 2018. As indicated by Figure 24, an economy with sounder policies and regulations is likely to attract higher FDI inflows, though the correlation is weak. Vietnam lacks a sound regulatory system but it performs well in attracting FDI; by contrast, Malaysia does relatively well in terms of formulating a good regulatory system but receives less FDI.

**FIGURE 24: REGULATORY QUALITY INDEX, 2018**




*Note: Scores for regulatory quality are taken from the World Bank's World Development Indicators. Regulatory quality is graded on a scale of -2.5 to 2.5 (-2.5 = low, 2.5 = high).*

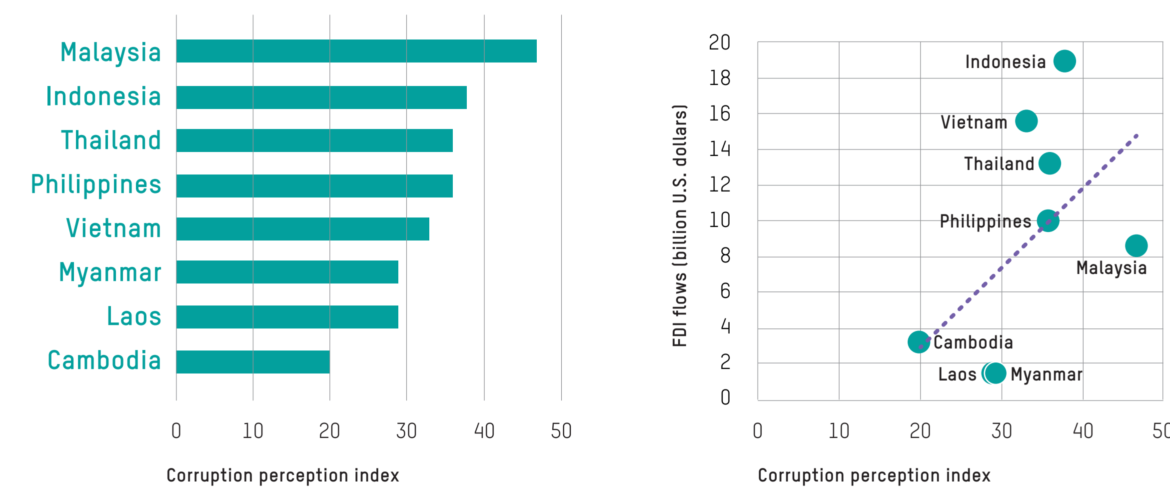
***Source: World Bank (2020).***



## PERCEPTIONS OF CORRUPTION

Corruption is widespread throughout ASEAN countries, though their average score on Transparency International's Corruption Perceptions Index (CPI) was 33.5 in 2018, considerably lower than the world average of 43. Moreover, seven of eight countries in the region (with the exception of Malaysia) scored below average. Figure 25 suggests that the correlation between perceptions of corruption and FDI flows is positive, indicating that high FDI flows are associated with tighter controls on corruption.

**FIGURE 25: CORRUPTION PERCEPTIONS INDEX, 2018**




*Note: Transparency International's CPI is graded on a scale of 0 to 100 (0 = highly corrupt, 100 = very clean).*

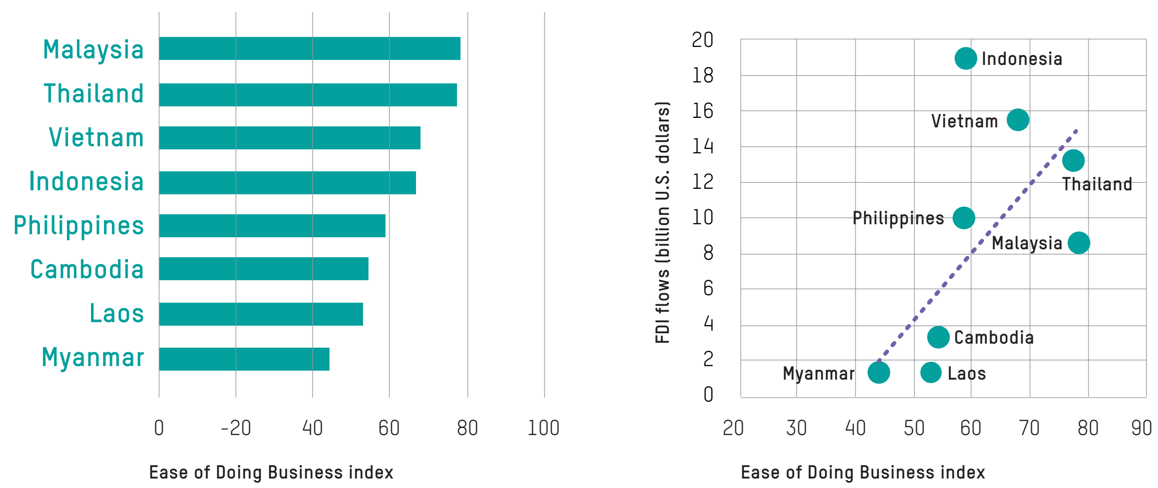
***Source: Transparency International (2020).***

*A fisherman preparing his fishing line*
Photo: Oxfam

## EASE OF DOING BUSINESS

The ease of doing business in a particular economy reflects the degree to which its regulatory environment supports the operation of businesses locally. The ease of doing business in ASEAN countries varies enormously, with Malaysia and Thailand scoring 78.43 and 77.44 respectively on the World Bank's Ease of Doing Business index in 2018, while Myanmar scored below average. Figure 26 implies a positive correlation between the ease of doing business and FDI inflows in ASEAN countries. Countries with regulatory environments that are conducive to business are likely to be more attractive to foreign investors.

### FIGURE 26: EASE OF DOING BUSINESS INDEX, 2018




*Note: Ease of Doing Business scores are taken from the World Bank's World Development Indicators. The ease of doing business is graded on a scale of 0 to 100 (0 = low, 100 = high).*

***Source:* *World Bank (2020).***

## PROTECTION OF INTELLECTUAL PROPERTY RIGHTS

The World Economic Forum (WEF) assesses IPR protection to be relatively efficient in Malaysia, while in Thailand and the CLMV countries protection remains basic compared with other countries, both elsewhere in the region and globally (WEF, 2017). There are significant gaps in IPR protection between the four countries placed first in the regional ranking, but there is no obvious difference between the three last places. In the scatter plot in Figure 27, the points are distributed randomly, indicating a weak or no relationship between protection of intellectual property and FDI flows.

### FIGURE 27: INTELLECTUAL PROPERTY PROTECTION, 2018


*Note: No data available for Myanmar. Scores for IPR protection indices are taken from WEF (2017) and graded on a scale from 1 to 7 (1 = low, 7 = high).*

***Source: WEF (2017).***

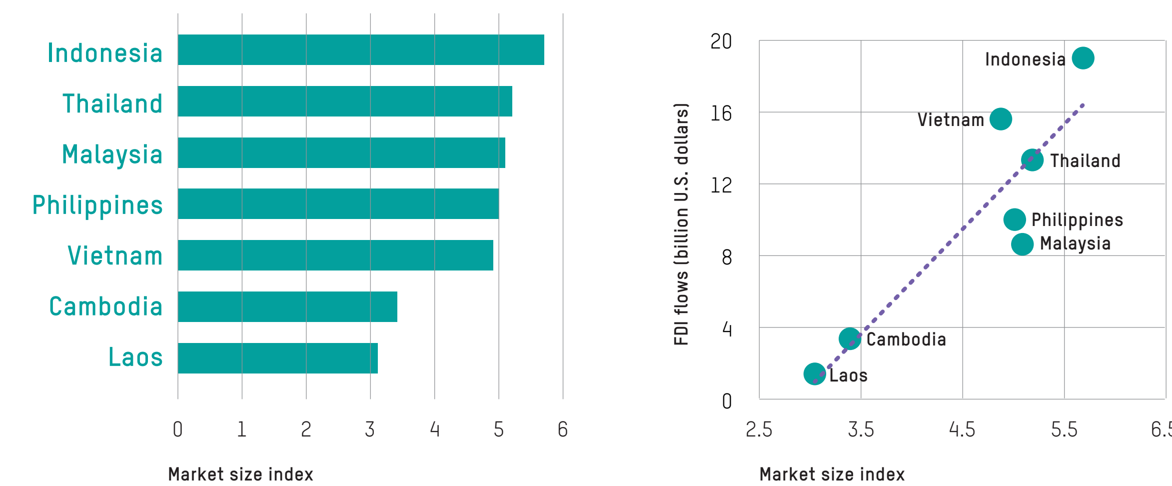


# 3.2.3 MARKET DEVELOPMENT

## MARKET SIZE

In Figure 28, FDI flows appear to be strongly and positively associated with market size, and there is a distinct gap in market sizes which divides ASEAN countries into two separate groups in the scatter plot. According to WEF data, Cambodia and Laos in the first group have smaller markets and lower FDI flows, while the other countries have larger markets and higher FDI flows. The positive correlation between market size and FDI flows is more robust in the first group than in the second. For example, Vietnam has the smallest market size in the latter group but receives the second highest FDI flows, while Malaysia ranks third in market size but fifth in FDI flows.

### FIGURE 28: MARKET SIZE, 2018



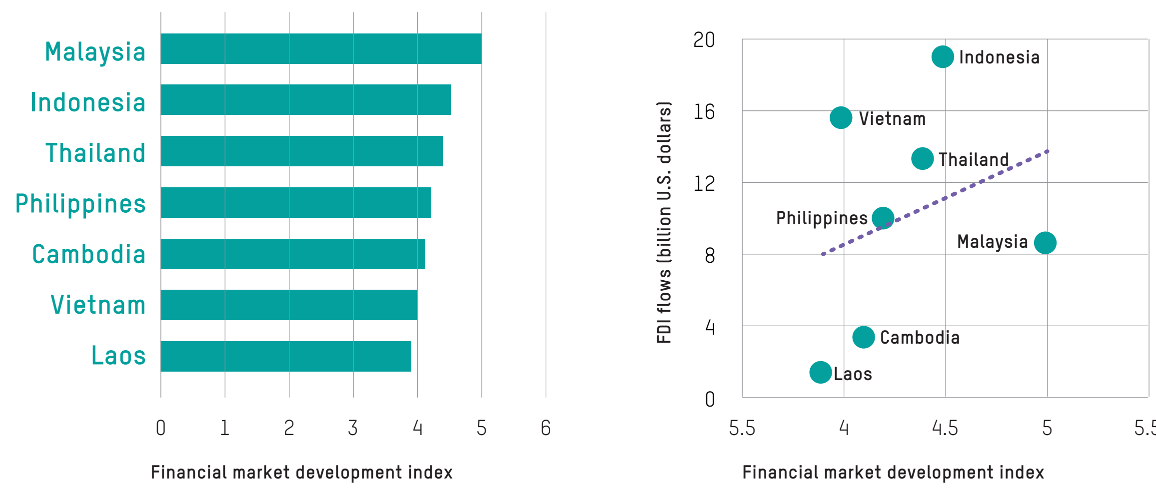

*Note: No data available for Myanmar. Scores for market size are taken from WEF (2017), and are graded on a scale of 1 to 7 (1 = small, 7 = large).*

***Source: WEF (2017).***

## DEVELOPMENT OF FINANCIAL MARKETS

The financial sectors of ASEAN countries still have plenty of room for improvement. Malaysia has the most developed financial market in the region, with a score of 5 out of a possible 7, according to the WEF. The scores of other ASEAN countries range from 3.9 for Laos to 4.5 for Indonesia. As shown in Figure 29, a robust financial market is associated with higher FDI flows. Malaysia is an exception, ranking first in the region in terms of financial market development but fifth in terms of FDI flows.

**FIGURE 29: DEVELOPMENT OF FINANCIAL MARKETS, 2018**



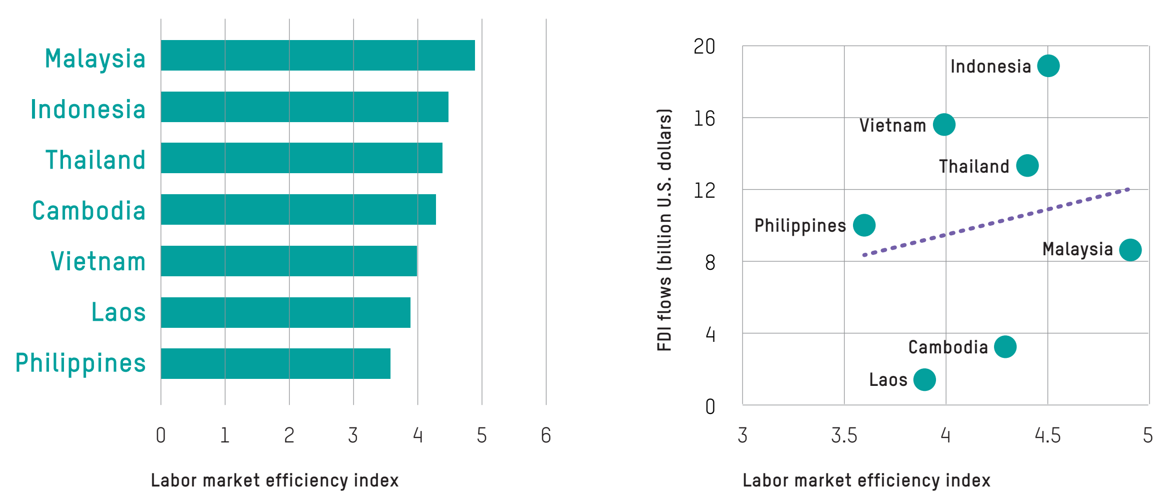

*Note: No data available for Myanmar. Scores for development of financial markets are taken from WEF (2017) and are graded on a scale of 1 to 7 (1 = low, 7 = high).*

***Source:* WEF (2017).**

## LABOR MARKET EFFICIENCY

There are no great differences between ASEAN countries in the efficiency of their labor markets. The gap between the most and least efficient labor markets is only 1.3, according to the WEF's scoring criteria. Malaysia has the most efficient labor market, while the Philippines has the least efficient. The association between labor market efficiency and FDI flows is positive but weak. Although they have inefficient labor markets, Vietnam and the Philippines rank among the biggest recipients of FDI in the region.

**FIGURE 30: LABOR MARKET EFFICIENCY, 2018**




*Note: No data available for Myanmar. Scores for labor market efficiency are taken from WEF (2017), based on an index of hiring and firing practices. Labor market efficiency is graded on a scale of 1 to 7 (1 = low, 7 = high).*

***Source:* WEF (2017).**

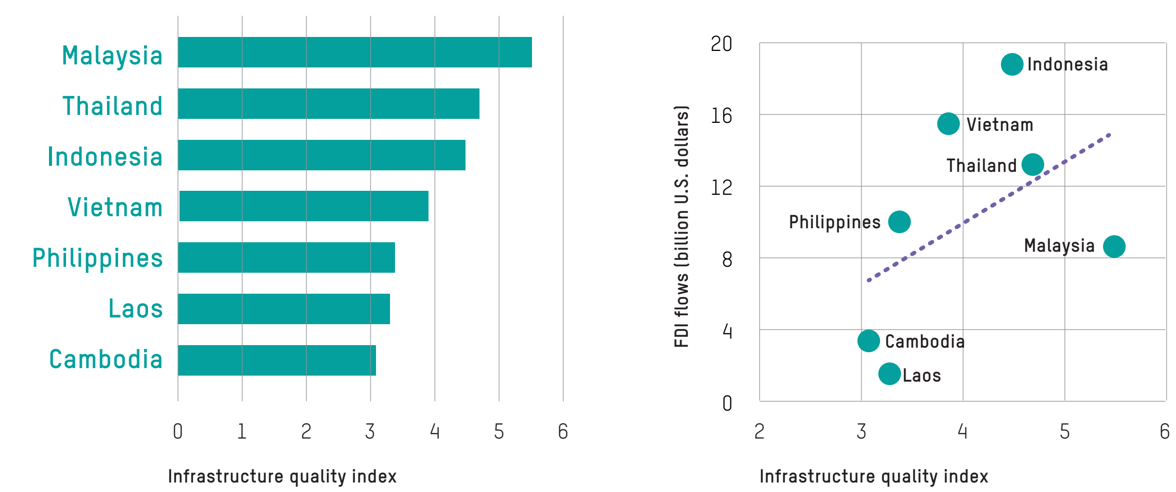


# 3.2.4 OTHER FACTORS

## INFRASTRUCTURE

ASEAN countries show wide variations in the quality of their infrastructure. Malaysia's infrastructure score is 5.5 on the WEF's seven-point scale, significantly different from Cambodia's score of 3.1, the lowest in the region. Improving the quality of infrastructure still presents a challenge to promoting business in the Philippines, Laos, and Cambodia. High-quality infrastructure is closely correlated with large flows of FDI; for example, Cambodia and Laos lag behind in terms both of infrastructure development and FDI flows. There are some exceptions, such as Malaysia, which has excellent infrastructure but attracts less FDI than countries with less developed infrastructure, like Vietnam and the Philippines.

**FIGURE 31: INFRASTRUCTURE DEVELOPMENT, 2018**



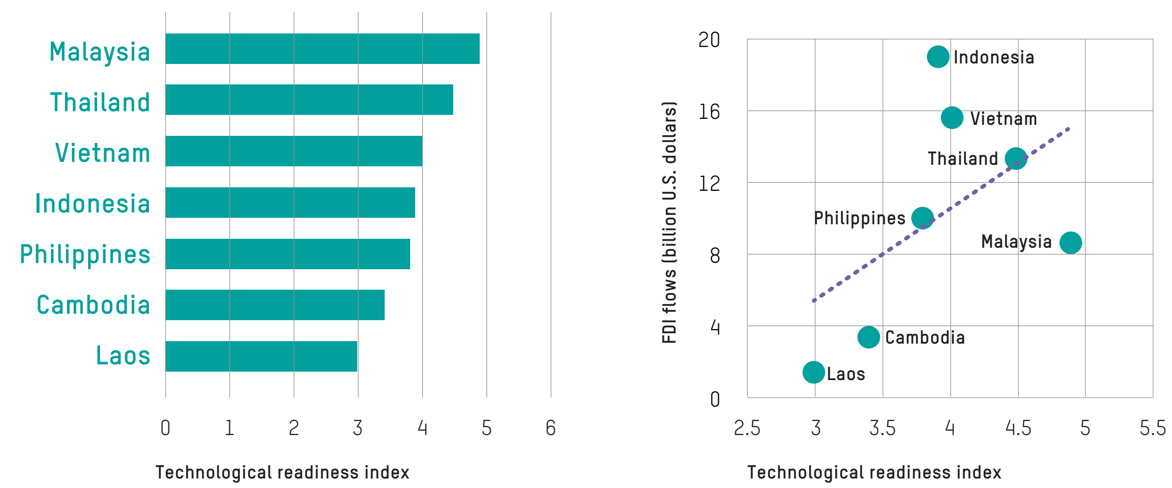

*Note: No data available for Myanmar. Scores for infrastructure are taken from WEF (2017) and are graded on a scale of 1 to 7 (1 = low, 7 = high).*

***Source:* WEF (2017).**

## TECHNOLOGICAL READINESS

Technological readiness varies tremendously across ASEAN countries. Levels are high in Malaysia and Thailand, while significant improvements are needed in other developing countries in the region, especially Laos, which scores only 3 on the WEF's seven-point scale. Figure 32 shows that there is a positive and strong relationship between technological readiness and FDI flows. A country that performs better on technological readiness attracts more FDI, and it is also likely that FDI will have spillover effects on the technological level of a host country.

### FIGURE 32: TECHNOLOGICAL READINESS, 2018



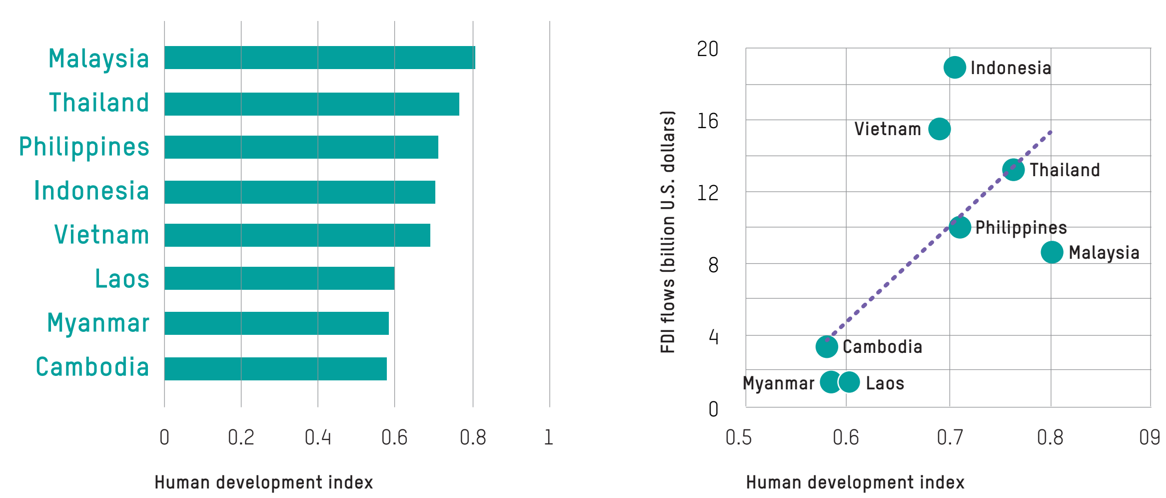

*Note: No data available for Myanmar. Scores for technological readiness are taken from WEF (2017) and are graded on a scale of 1 to 7 (1 = low, 7 = high).*

***Source: WEF (2017).***

## HUMAN DEVELOPMENT

Malaysia leads the region with an impressive human development score of over 0.8 in UNDP's HDI. However, there is room for improvement in human development in other countries in the region. Six of the 10 ASEAN Member States scored below the world average of 0.76 in 2018. The CLMV countries scored the lowest, with Vietnam the only one of the four to score more than 0.6. A positive correlation between human development and FDI flows can be seen in Figure 33. The scatter plot also shows two distinct groups: Cambodia, Laos, and Myanmar are characterized by poor performance in both human development and attracting FDI, while the other countries excel at both.

### FIGURE 33: HUMAN DEVELOPMENT INDEX, 2018




*Note: Scores for human development are taken from UNDP's Human Development Reports and are graded on a scale of 0 to 1 (0 = low, 1 = high).*

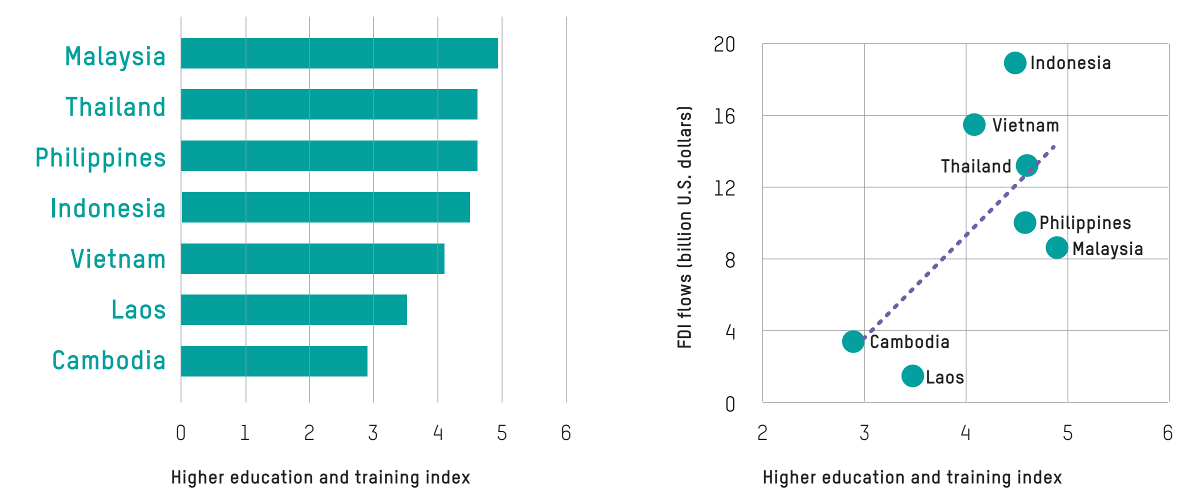
***Source: UNDP Human Development Reports (2020).***



## HIGHER EDUCATION AND TRAINING

Overall, the quality of higher education and training in ASEAN is low, with the region's highest-ranked country, Malaysia, ranking only 45th in the world. The gaps between Malaysia, the Philippines, Thailand, and Indonesia are quite narrow, while the gap between the three lowest-ranked countries in the region, Vietnam, Laos, and Cambodia, is wide. There is a positive correlation between the quality of higher education and training and FDI flows. Indonesia, Malaysia, the Philippines, Thailand, and Vietnam, all with relatively advanced higher education, are large recipients of FDI, while Laos and Cambodia, on the other hand, are lacking both in the quality of higher education and training and FDI inflows.

### FIGURE 34: HIGHER EDUCATION AND TRAINING, 2018




*Note: No data available for Myanmar. Scores for higher education and training are taken from WEF (2017) and are graded on a scale of 1 to 7 (1 = low, 7 = high).*

***Source: WEF (2017).***

*Junior high school students in Vietnam*
Photo: Oxfam

# 3.3 DISCUSSION

Economic openness, the ease of doing business, market size, and human development are the factors that have the strongest positive linear correlation with FDI flows. Most other factors also have positive correlations and only three – IPR protection, financial market development, and labor market efficiency – have weak or no linear correlation. The low linear correlation coefficients of the efficiency of financial and labor markets with FDI reflect results from previous research which confirm weak or non-linear relationships between these two factors and inward investment. In particular, Soumaré and Tchana Tchana (2015) identify that stock markets have a strong effect on FDI, but there is insufficient evidence to confirm the effects of the banking sector, which may result in an ambiguous relationship between the overall financial market and the amount of FDI a country receives. Parcon (2008) finds a non-linear relationship between the labor market and FDI, caused by the two opposing effects on FDI inflows of labor market flexibility. A highly regulated labor market can provide job security and bring social stability, which attracts FDI, but a rigid labor market raises the costs of hiring and firing, which deters FDI inflows.

With respect to business environment factors that have some positive linear relationship with FDI flows, ASEAN countries often fall into two distinct groups, one of which has both favorable business environments and high flows of FDI while the other has unfavorable business environments and low FDI flows. For most factors except for economic freedom, the former group consists of Indonesia, Malaysia, the Philippines, Thailand, and Vietnam, while the latter includes Cambodia, Laos, and Myanmar. Significant efforts are needed to enhance the investment climate if the latter group of countries is to increase the amount of FDI they attract. Human development in Cambodia, Laos, and Myanmar is still lacking, which is an obstacle to these countries attracting FDI into manufacturing industries, which are often labor-intensive. The poor condition of their business environments, particularly institutional quality, may explain why these three countries are highly dependent on Chinese FDI, which tends to be attracted to resource-rich countries with poor institutional quality (Kolstad and Wiig, 2012).

Indonesia, Malaysia, the Philippines, Thailand, and Vietnam all have more favorable business environments and subsequently have higher FDI flows than Cambodia, Laos, and Myanmar. This reflects the findings of the OECD (2019) that major reforms aimed at liberalization in four of these countries[2] have been followed by increases in FDI flows. Of the five countries in this group, Vietnam's business environment is the least favorable, with a restricted economy, a relatively unattractive investment environment, inefficient institutions, and a small market size; surprisingly, however, Vietnam ranks behind only Indonesia in terms of attracting FDI. On the other hand, despite possessing the most favorable business environment in the region, Malaysia receives the smallest amount of FDI of the five countries. This implies that there must be other factors that play important roles in companies' choices about where to invest.

(2) The OECD study did not look at the effects on FDI of liberalization reforms in Thailand.

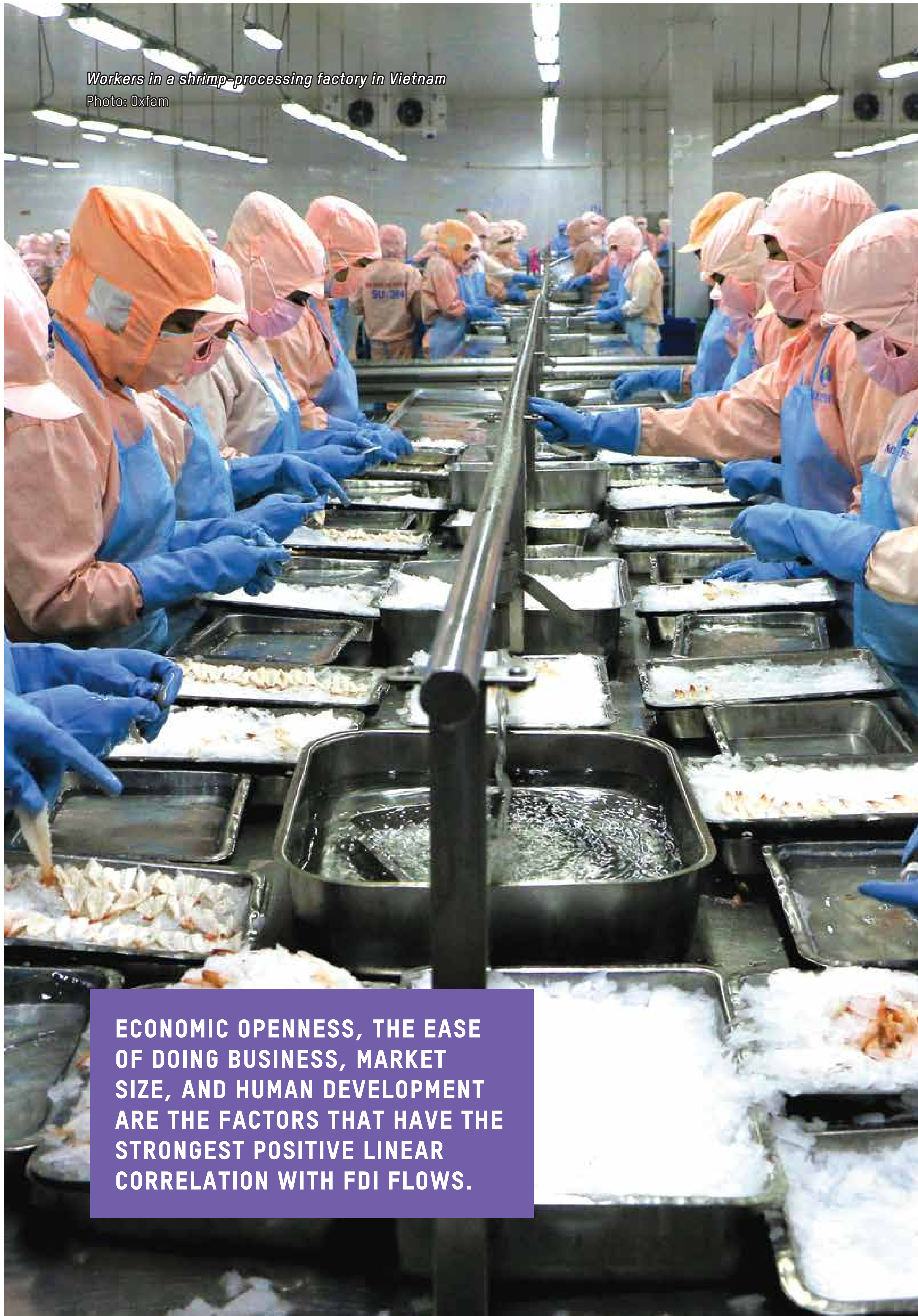


**TABLE 2: SUMMARY OF BUSINESS ENVIRONMENT FACTORS AND THEIR CORRELATION WITH FDI FLOWS**

| BUSINESS ENVIRONMENT FACTORS | LINEAR CORRELATION WITH FDI FLOWS | | | HIGHLY RANKED COUNTRIES | POORLY RANKED COUNTRIES |
|---|---|---|---|---|---|
| | STRONG, POSITIVE | MODERATE, POSITIVE | WEAK/NO ASSOCIATION | | |
| **MACRO-ECONOMIC ENVIRONMENT** | | | | | |
| Macro-economic environment | | ✓ | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos |
| Economic freedom | | ✓ | | Cambodia, Indonesia, Philippines, Thailand | Laos, Malaysia, Myanmar, Vietnam |
| Economic openness | ✓ | | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos, Myanmar |
| Investment environment | | ✓ | | | |
| **INSTITUTIONAL QUALITY** | | | | | |
| Government effectiveness | | ✓ | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos, Myanmar |
| Regulatory quality | | ✓ | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos, Myanmar |
| Perceptions of corruption | | ✓ | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos, Myanmar |
| Ease of doing business | ✓ | | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos, Myanmar |
| Protection of intellectual property rights | | | ✓ | N/A | N/A |
| **MARKET DEVELOPMENT** | | | | | |
| Market size | ✓ | | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos |
| Financial market development | | | ✓ | N/A | N/A |
| Labor market efficiency | | | ✓ | N/A | N/A |
| **OTHER FACTORS** | | | | | |
| Infrastructure | | ✓ | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos |
| Technological readiness | | ✓ | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos |
| Human development | ✓ | | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos, Myanmar |
| Higher education and training | | ✓ | | Indonesia, Malaysia, Philippines, Thailand, Vietnam | Cambodia, Laos |

*Note: The correlation is strong and positive if the Pearson correlation coefficient is at least 0.65; it is moderate and positive if the correlation coefficient ranges from 0.3 to 0.65; and it is weak or there is no association if the correlation coefficient is smaller than 0.3.*

***Source: Authors' calculations and classification.***



*Workers in a shrimp-processing factory in Vietnam*
Photo: Oxfam

**ECONOMIC OPENNESS, THE EASE OF DOING BUSINESS, MARKET SIZE, AND HUMAN DEVELOPMENT ARE THE FACTORS THAT HAVE THE STRONGEST POSITIVE LINEAR CORRELATION WITH FDI FLOWS.**

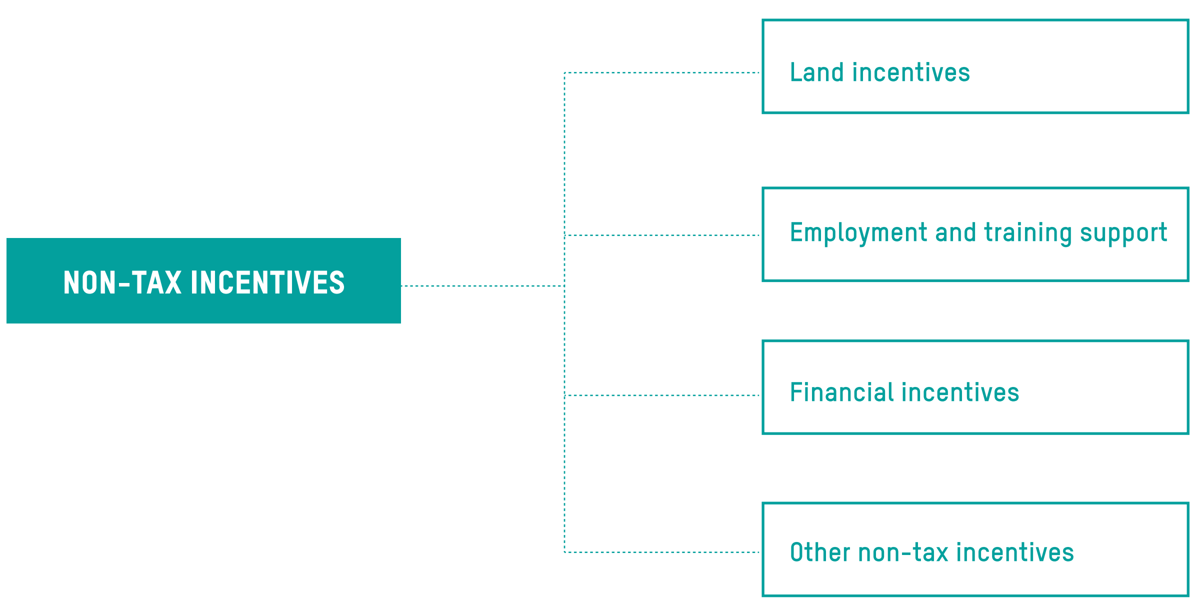
# 4

# NON-TAX INCENTIVES AND FDI FLOWS IN ASEAN COUNTRIES

In addition to tax incentives, various non-tax incentives play a part in the competition between ASEAN countries to attract FDI, especially between Indonesia, Malaysia, the Philippines, Thailand, and Vietnam. Non-tax investment incentives in the region are commonly provided in the form of land incentives, employment supports, and financial incentives. ASEAN countries compete mainly by offering land incentives, and this has developed into a detrimental race that adversely affects local societies and the quality of governance.

Although more studies are now available on the impacts of the business environment and tax incentives on FDI, research is still lacking with regards to non-tax incentives. It is difficult to pinpoint the specific impacts that such incentives have on FDI as most studies combine tax and non-tax incentives into a single category of investment incentives and do not examine non-tax incentives as a separate subject. Since no previous research has looked into the effects of non-tax incentives on FDI flows into ASEAN countries, this report refers to the research on non-tax incentives in other regions to study investors' general perceptions towards non-tax incentives.

**FIGURE 35: TYPES OF NON-TAX INCENTIVE**



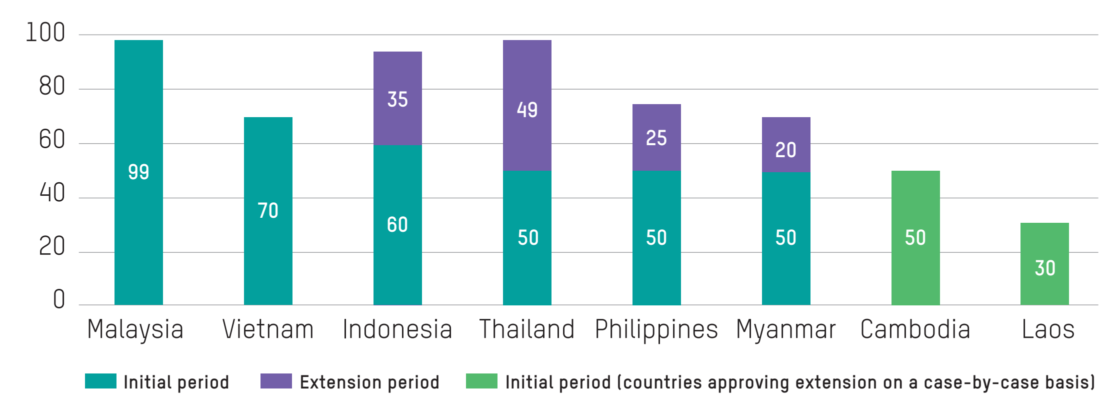

James (2009) finds that 80% of foreign investors would still invest even if no incentives were provided. This ratio is even higher in Vietnam, where 85% of investment projects would still have gone ahead even without incentives. Owczarczuk (2013) reports that in the Visegrad countries in central Europe (Poland, Hungary, the Czech Republic, and Slovakia) fiscal and financial incentives do not appear to be correlated with FDI flows into the research and development (R&D) sector. Of the four countries, Poland offers the poorest incentive packages but it still attracts more FDI than the others, which offer aggressive investment incentives including non-tax incentives such as cash grants, preferential prices for infrastructure or land, and benefits relating to patents.



## 4.1 LAND INCENTIVES

ASEAN countries compete with one another to offer various forms of land incentive. Foreign-invested enterprises are eligible for long-term land leases in all countries in the bloc. Figure 36 shows the maximum length of the initial land leases they offer, plus extension periods. Malaysia leads the pack in terms of initial leasehold periods, offering 99-year leases, without extensions. Thailand and Indonesia also offer long leasehold periods of 99 and 95 years respectively, including extensions. Cambodia and Laos offer the shortest initial land lease periods, but foreign investors in these countries can apply for extensions, which are decided on a case-by-case basis. In Thailand, in addition to long-term leases, businesses in certain sectors are eligible to apply for permission to own land. Rent exemptions and reductions are also available in specific economic areas of some ASEAN countries and vary according to the socio-economic status of the area. In Vietnam and Laos, projects can be exempted from rent payments for up to 15 years initially in certain promoted sectors and hardship areas. In addition to rent holidays, Vietnam offers rent reductions of up to 50% for production and business activities in certain industries and for projects affected by natural disasters.

**FIGURE 36: MAXIMUM LENGTH OF LAND LEASE (INCLUDING EXTENSIONS) IN ASEAN COUNTRIES (YEARS)**




*Note: Extensions of expired land leases in Cambodia and Laos are approved on a case-by-case basis.*

***Source: Authors' review and classification.***

Due to the difficulties involved in quantifying land incentives, there is no clear evidence to confirm that such incentives have any significant effect on FDI inflows. Some studies find support for the view that foreign investors are interested in land incentives when deciding on FDI locations, while others believe that the impacts of such concessions are marginal. A survey by Dorożyński, Świerkocki, and Urbaniak (2014) indicates that foreign investors rate offers of developed investment land highly. On the other hand, according to Rolfe et al. (1993), investors from the US show little interest in land grants when considering investments in the Caribbean region. Of 20 types of incentive offered in the Caribbean, land grants rank only 17th, with a score of 3.94 on a nine-point scale. Foreign investors in the manufacturing sector are more interested in land grants than those in the services sector, which is not surprising because manufacturing firms need more land for their production activities (Rolfe et al., 1993). For example, in the ASEAN countries that offer generous land grants, including Malaysia, Vietnam, Indonesia, Thailand, and the Philippines, manufacturing is the industry that receives the most FDI. However, the survey by Rolfe at al. (1993) shows that land grants rank only 18th among manufacturing firms looking to set up in the Caribbean.

In many cases, the offering of land incentives has resulted in land being stolen from local communities and the widening of disparities in income. In Cambodia, economic land concessions have been found to hamper the process of collective land titling and registration by Indigenous communities. The process for granting concession licenses often moves more quickly than the process for collective land titling and registration, so concessions with overlapping claims on local areas create an obstacle to guaranteeing the rights of Indigenous people and their access to traditional lands (Prachvuthy, 2011). In Laos, hundreds of thousands of hectares of land have been appropriated from local communities and handed out in concessions, even though this land has not been properly utilized. The poorest groups in society, who rely upon access to land and natural resources, have lost their most important productive asset, and this has increased socio-economic disparities in the country (Hanssen, 2007).

Moreover, the lack of transparency in the process of granting land incentives creates fertile ground for corruption and inequality between businesses. In Cambodia and Laos, the extension of leasehold periods can be negotiated on a case-by-case basis and can be kept secret from the public, giving investors more bargaining power and creating opportunities for corruption and rent-seeking (UNCDF, 2010). In fact, these two countries rank worst in the region for corruptions of perception, with Laos scoring 29 and Cambodia 20 on a scale of 0 to 100.

## 4.2 EMPLOYMENT AND TRAINING SUPPORT

As discussed earlier, ASEAN countries rank poorly globally on higher education and training, so foreign firms often need to provide on-the-job training for workers in host countries to meet specific requirements or job qualifications. The costs of vocational training can discourage investment decisions by foreign businesses, especially SMEs. Recognizing this, some ASEAN countries offer labor-related investment incentives, including support for on-the-job training or human resources (HR) development. In Vietnam, HR training support programs are eligible for government funding, while the government has also introduced plans and programs to support SMEs that lack resources for employment and training programs. In Indonesia, the government offers support to businesses in need of vocational training in order to encourage HR development in the business sector. In Thailand, foreign investors are allowed to bring in skilled workers from other countries to avoid spending resources on training programs.

FDI-related training programs benefit host countries by giving local workers opportunities for exposure to personnel, management techniques, and new technologies by multinationals. For example, in Brazil, Citibank's training programs created skilled employees who then spread through the country's financial sector and contributed to its financial development (Moran, 2005). However, according to Rolfe et al. (1993), in terms of attractiveness to US investors in the Caribbean region, job training subsidies scored only 4.76 on a nine-point scale and ranked only 13th out of 20 incentives. Interestingly, market orientation and the size of investment make significant differences to preferences on job training subsidies. Exporters show greater interest in subsidies of this kind than investors who are oriented towards local markets. In Rolfe et al. (1993), job training subsidies are ranked 14th of 20 incentive types in their attractiveness to projects involving investment of less than $1m but 12th for investments of more than $1m, indicating that larger firms place more emphasis on job training subsidies than smaller firms. This calls into question the effectiveness of Vietnam's incentives for HR development, which focus on SMEs.

**TABLE 3: SUMMARY OF EMPLOYMENT AND TRAINING SUPPORTS IN ASEAN COUNTRIES**

| COUNTRY | DETAILS |
|---|---|
| **Cambodia** | N/A |
| **Indonesia** | Vocational training support<br>HR programs for SMEs |
| **Laos** | N/A |
| **Malaysia** | N/A |
| **Myanmar** | N/A |
| **Philippines** | N/A |
| **Thailand** | Foreign investors are permitted to bring in skilled workers |
| **Vietnam** | Vocational training support |

*Source: Authors' review and classification.*

# 4.3 FINANCIAL INCENTIVES

Malaysia and Indonesia both prefer to use financial incentives to stimulate investment in promoted industries. Malaysia offers a total of eight soft loan schemes and 18 other schemes, including rebates, to attract investment. Its soft loan schemes focus on manufacturing and related services, and on financing services for franchises. Rebate programs and other schemes address franchises and R&D. In Indonesia, financial incentives also focus on R&D, with low interest rates offered on loans for such activities.

Similar to employment and training support, subsidized loans are not ranked highly in terms of attractiveness to foreign investors, however. They score 5.43 (out of 9) and are ranked 10th out of 20 in terms of attractiveness to US investors in the Caribbean region, for example. There are also differences between the preferences of large and small investment projects for subsidized loans: they rank one place higher in terms of attractiveness for large companies than for smaller ones (Rolfe et al., 1993). Hintosova and Rucinsky (2017) also argue that in general financial incentives do not have any statistically significant relationship with FDI inflows.

**TABLE 4: SUMMARY OF FINANCIAL INCENTIVES IN ASEAN COUNTRIES**

| COUNTRY | DETAILS |
|---|---|
| Cambodia | N/A |
| Indonesia | Soft loans for R&D and vocational training |
| Laos | N/A |
| Malaysia | Eight soft loan programs (e.g. Bioeconomy Transformation Program (BTP))<br>Rebate programs (e.g. Green Technology Financing Scheme 2.0) |
| Myanmar | N/A |
| Philippines | N/A |
| Thailand | N/A |
| Vietnam | N/A |

*Source: Authors' review and classification.*



# 4.4 OTHER INCENTIVES

There are other non-tax incentives available in ASEAN countries. Some involve facilitating immigration or entry visas for personnel. Foreign investors in Laos are helped to facilitate migration for a maximum period of five years; investors in the Philippines benefit from the facilitation of immigration for investments of $75,000 and above; and investors in Vietnam are eligible for facilitation of both entry visas and immigration. Thailand allows prospective investors to enter the country for the purpose of studying investment opportunities. In Malaysia and Vietnam, foreign investors also receive assistance with the costs of equipment and infrastructure, while in Philippines the government offers privileges to companies operating bonded manufacturing or trading warehouse facilities.

**TABLE 5: SUMMARY OF OTHER INCENTIVES IN ASEAN COUNTRIES**

| COUNTRY | DETAILS |
|---|---|
| Cambodia | N/A |
| Indonesia | N/A |
| Laos | Facilitation of migration for foreign investors for a maximum of five years |
| Malaysia | Discounts on costs of equipment |
| Myanmar | N/A |
| Philippines | Facilitation of immigration for expatriates in projects investing a minimum of $75,000<br>Privileges in operating bonded manufacturing/trading warehouse facilities |
| Thailand | Permits for foreign nationals to enter the Kingdom for the purpose of studying investment opportunities |
| Vietnam | Facilitation of immigration and migration<br>Exemption from or reduction in charges for use of infrastructure |

*Source: Authors' review and classification.*

A farmer in Minh Tan, Phu Xuyen
Photo: Oxfam

# 5

# CONCLUSIONS AND RECOMMENDATIONS

This report discusses the role of the business environment and non-tax incentives in the promotion of investment in ASEAN countries by conducting a literature review and examining correlations between FDI flows and their drivers. We conclude that, while competition between countries in terms of their business environments is a race to the top, competing on non-tax incentives means a race to the bottom.

ASEAN has become increasingly attractive to foreign investors, as evidenced by the growth of FDI flows since 2016, driven mainly by a surge of investment in manufacturing. Between 2019 and 2020, of the 10 ASEAN countries four (Brunei, Cambodia, Thailand, and Vietnam) have seen an increase in the amount of FDI received, though the other six have seen a decrease.

Consistent with earlier research, this report suggests that the business environment has a significant and positive effect on the decisions of MNCs about where to locate FDI projects. Statistics show that economic openness, ease of doing business, market size, and human development are the key business environment drivers of FDI into the ASEAN region. Of the 10 countries in the bloc, Singapore and Brunei have the most favorable environments for business. Singapore, as the region's main tax haven, receives the largest amount of inward FDI. Brunei's FDI inflows, on the other hand, are the smallest in the region, which is perhaps not surprising as the country's population and market size are relatively small compared with other countries. Indonesia, Malaysia, the Philippines, Thailand, and Vietnam receive high levels of FDI inflows, especially into their manufacturing sectors, due to their relatively skilled and educated workforces. FDI flows into Cambodia, Laos, and Myanmar still lag behind and depend to a great extent on FDI from China due to their poor institutional quality. When making FDI location decisions, Chinese multinationals tend to opt for resource-rich countries with poor of institutional quality (Kolstad and Wiig, 2012).

Non-tax incentives such as land incentives exacerbate the race to the bottom, due to their high costs and their marginal positive effects in attracting FDI. The competition between ASEAN countries on land incentives is leading to land being stolen from local communities, widening socio-economic inequalities. In Cambodia, Laos, and Myanmar, the granting of land incentives, in particular the extension of leasehold terms, lacks transparency, which may increase the risks of corruption. Indonesia, Malaysia, the Philippines, Thailand, and Vietnam are also engaged in competition to provide employment and training supports and financial and other incentives, none of which have been proven to have any significant effects on investors' decisions about where to locate FDI projects.

Coordinated efforts by ASEAN countries are urgently needed to halt the detrimental race to the bottom caused by these redundant incentive packages. FDI inflows into developing Asian countries are predicted to fall by 30–40% as a consequence of the global economic downturn caused by the COVID-19 pandemic, leading to reductions in tax revenues collected from corporate income taxes. In addition, the health and economic crisis caused by COVID-19 poses enormous challenges for sustainable development in the ASEAN region. Poverty and economic inequality are already at high levels, and are predicted to worsen further due to the pandemic. New analysis by the United Nations University World Institute for Development Economics Research (UNU-WIDER) estimates that a 20% contraction of income and consumption in the Asia-Pacific region will see an additional 214.1 million people pushed below the poverty line of $5.50 a day (Sumner, Hoy, and Ortiz-Juarez, 2020).

Growing demands for budget spending to tackle both poverty and inequality and the reduction in FDI inflows are posing serious challenges for the national budgets of ASEAN countries. This context calls for ASEAN Member States to come together and agree to stop the race to the bottom and improve their business environments to attract long-term and sustainable FDI and to provide fiscal resources to deal with the pandemic. This report makes the following recommendations.



## RECOMMENDATION 1:

### AGREE UPON MEASURES TO IMPROVE THE BUSINESS ENVIRONMENT, FOCUSING ON THE KEY FACTORS.

ASEAN Member States should sit down together and agree on a 'race to the top' by improving the business environment factors that have significant impacts on FDI inflows. The top priorities should be economic openness, the administrative burden when doing business, and human capital.

In parallel with this, ASEAN countries should make efforts to enhance other indicators of the macro-economic environment and institutional quality, such as economic freedom, government effectiveness, regulatory quality, quality of infrastructure, and technological readiness. This would help them to reorient investment promotion and avoid overspending on relatively unimportant aspects such as development of the banking sector.

## RECOMMENDATION 2:

### STOP COMPETING TO PROVIDE LAND INCENTIVES.

ASEAN countries need to stop competing with one another to offer land incentives as a means of attracting FDI due to the harm that such incentives do to local societies in the form of land conflict and disparities in income. Exemptions from paying rent on land should be phased out of location incentive packages. Member States should also take a cross-regional approach to standards on economic land concessions, in particular agreeing on a maximum length of 50 years for leasehold periods across ASEAN. Governments should also authorize adjustments to rents on a five-year basis, rather than fixing rent levels for the whole period of the lease.

Instead of offering land incentives, ASEAN countries need to coordinate efforts and their budgets to develop infrastructure components such as roads and utilities, especially in industrial and economic zones, for the purpose of attracting FDI.

## RECOMMENDATION 3:

### CONSTRUCT A RULEBOOK ON GRANTING NON-TAX INCENTIVES AND DEVELOP A TRANSPARENT AND ACCOUNTABLE REPORTING MECHANISM.

To increase transparency and accountability when granting non-tax incentives, ASEAN countries need to develop a set of rules with clear timelines and criteria for selecting recipients for each type of incentive. They should avoid granting incentives on a case-by-case basis, which can create opportunities for corrupt practices. Member States should also develop a transparent and accountable mechanism for reporting the incentives granted to ensure cooperation across the region. This mechanism should involve multiple stakeholders, such as CSOs and academic institutions.

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