

United Nations Conference on Trade and Development

***Investment Advisory Series***  
***Series B, number 6***

***Best Practices in Investment  
for Development***

How to attract and benefit from FDI in small countries  
Lessons from Estonia and Jamaica



United Nations

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**BEST PRACTICES IN  
INVESTMENT FOR  
DEVELOPMENT**

**CASE STUDIES IN FDI**

**How to Attract and Benefit from FDI  
in Small Countries:**

**Lessons from Estonia and Jamaica**



**UNITED NATIONS  
New York and Geneva, 2011**

## NOTE

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Use of a dash (–) between dates representing years – for example 2004–2005 signifies the full period involved, including the beginning and end years.

Reference to the “dollars” (\$) means United States dollars, unless otherwise indicated.

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## PREFACE

The *Investment Advisory Series* provides practical advice and case studies of best policy practice for attracting and benefiting from foreign direct investment (FDI), in line with national development strategies. The series draws on the experiences gained in, and lessons learned through, UNCTAD's capacity-building and institution-building work in developing countries and countries with economies in transition.

Series A deals with issues related to investment promotion and facilitation and to the work of investment promotion agencies (IPAs) and other institutions that promote FDI and provide information and services to investors. The publications are intended to be pragmatic, with a how-to focus, and they include toolkits and handbooks. The prime target audience for series A is practitioners in the field of investment promotion and facilitation, mainly in IPAs.

Series B focuses on case studies of best practices in policy and strategic matters related to FDI and development arising from existing and emerging challenges. The primary target audience for series B is policymakers in the field of investment. Other target audiences include civil society, the private sector and international organizations. Series B was launched in response to a call at the 2007 Heiligendamm G-8 Summit for UNCTAD and other international organizations to undertake case studies in making FDI work for development. It analyses practices adopted in selected countries in which investment has contributed to development, with the aim of disseminating best practice experiences to developing countries and countries with economies in transition. The analysis forms the basis of a new technical assistance work programme aimed at helping countries to adopt and adapt best practices in the area of investment policies.

For Series B, UNCTAD's approach is to undertake case studies of a pair of developed and developing or transitional economies that exhibit elements of best practices in a selected issue. Country selection follows a standard methodology, based primarily on the significant presence of FDI and resulting positive outcomes.

The *Investment Advisory Series* is prepared by a group of UNCTAD staff and consultants in the Investment Policies Branch, under the guidance of Joerg Weber and Chantal Dupasquier. This study of the Series B was prepared by Stephen Young, Marek Tiits, Noel Watson and Rory Allan. Fact-finding missions were undertaken in Estonia and Jamaica in late 2007 and early 2008. The report was finalized by John Kline, Ioanna Liouka and Cam Vidler. Contributions and comments were received from Torbjörn Fredriksson, Thomas Westcott, Hans Baumgarten and Antje Watermann. The report has also benefited from views of current and former Government officials, the domestic and foreign private sector and academics. The programme receives financial support from the Government of Germany.

Geneva, July 2011

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**ABBREVIATIONS**

BCDP	Bauxite Community Development Programme
BIT	bilateral investment treaty
BPO	business process outsourcing
CARICOM	Caribbean Community
CEE	Central and Eastern Europe
CET	common external tariff
CIS	Commonwealth of Independent States
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
FZ	free zone
GDP	gross domestic product
ICT	information and communication technology
IDB	Inter-American Development Bank
IMF	International Monetary Fund
IPA	investment promotion agency
IPR	intellectual property rights
JBI	Jamaica Bauxite Institute
JCCP	Jamaica Cluster Competitiveness Project
JTI	Jamaica Trade and Invest
M&A	merger and acquisition
MFA	Multi-Fibre Arrangement
NAFTA	North American Free Trade Agreement
NIP	National Industrial Policy (Jamaica)
PSDP	Private Sector Development Programme
R&D	research and development
RHQ	Regional Headquarters
SME	small and medium-sized enterprise
TNC	transnational corporation
UNESCO	United Nations Educational, Scientific and Cultural Organization
USITC	United States International Trade Commission
WTO	World Trade Organization

### Estonia



### Jamaica



### KEY FACTS TABLE

	Estonia			Jamaica		
	1995-2000	2001-2006	2007-2010	1995-2000	2001-2006	2007-2010
<b>Population (millions)*</b>	1.37	1.34	1.31	2.57	2.68	2.70
<b>Annual GDP growth (%)</b>	5.2	8.3	-2.9	-0.2	1.7	1.6
<b>GDP per capita (\$)*</b>	4106.7	12232.5	14661.3	3485.4	4468.6	5097.2
<b>GDP by sector (%)</b>						
Services	57.6	59.6	68.8	62.0	64.8	64.6
Industry	26.5	25.5	28.7	24.2	22.0	29.7
Agriculture	4.7	3.3	2.5	7.2	5.4	5.7
<b>FDI inflows (annual average) (\$ million)</b>	315.2	1240.3	1958.3	316.0	663.3	761.25
<b>FDI outflows (annual average) (\$ million)</b>	55.3	425.9	1135.1	77.9	87.6	79.7
<b>FDI inflows (% of GDP)</b>	6.1	11.4	9.4	3.9	6.5	5.7
<b>FDI inflows (% gross fixed capital formation)</b>	22.5	36.4	35.5	16.3	24.1	25.8
<b>Exports of goods and services (% GDP)</b>	72.5	76.4	75.2	40.5	36.5	39.2
<b>Imports of goods and services (% GDP)</b>	80.3	84.3	76.6	49.3	52.9	66.3

Source: UNCTAD, FDI/TNC database and GlobStat database.

\* Data are for 2000, 2006 and 2010 only.



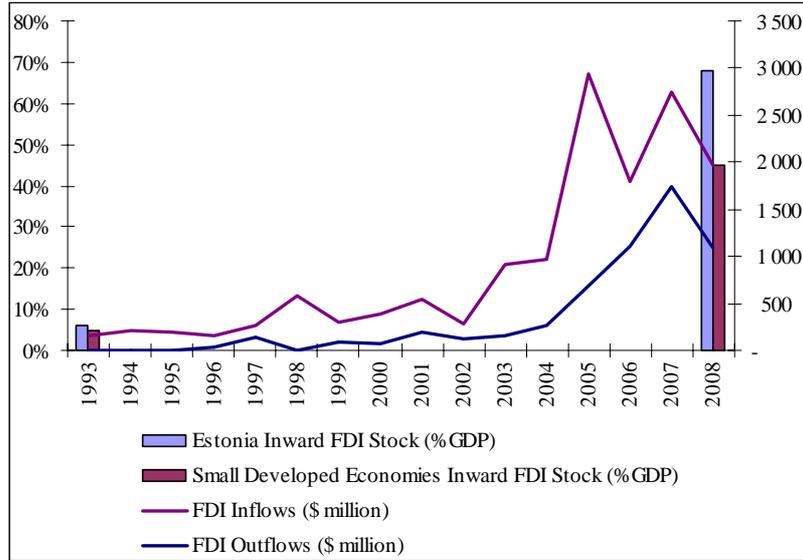
## I. INTRODUCTION

Small countries – defined in this study as those with a population of less than 3 million – face particular challenges in attracting foreign direct investment (FDI), and in maximizing its benefits for economic development. This study selects two small economies that have demonstrated success over the last two decades in overcoming the constraints of size, thus achieving a strong record of FDI attraction and associated benefits.

Since 1990, Estonia and Jamaica have managed to outperform many other small countries in attracting foreign investors. At the end of 2008, FDI stock as a share of gross domestic product (GDP) was close to 70 per cent in the case of Estonia and 72 per cent for Jamaica, well above the equivalent level for small developed countries (with which Estonia is compared) and small developing countries (with respect to Jamaica) (figures I.1 and I.2). The large flows of FDI have provided direct and indirect economic benefits to both countries.

The objectives of this study are to compare and contrast: *first*, Estonia's and Jamaica's approach to setting objectives relating to inward FDI; *second*, the methods in the form of policy instruments used to achieve these objectives; and *third*, the results and impact. This study draws out the characteristics of policies that illustrate best practices, and identifies policies that were not as effective, with the aim of distilling policy lessons for small countries in attracting and benefiting from FDI. Estonia and Jamaica are interesting cases to compare because of their different policy approaches. Jamaica's emphasis on State planning contrasts with Estonia's pro-market reform strategy. Thus, this study does not seek to identify which approach is best for small countries in all circumstances, but more about how to adapt general policy lessons to unique national contexts.

**Figure I.1. Estonia – FDI inflows, outflows and inward FDI stock as % of GDP**

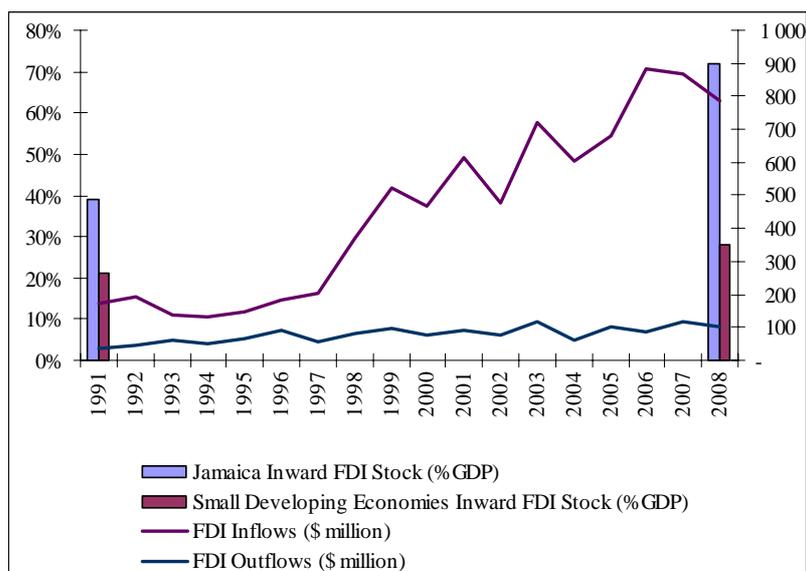


Source: UNCTAD, FDI/TNC database.

### *Challenges faced by small economies*

There are 67 small developing and transitional economies with less than 3 million people. These countries face three main challenges with respect to attracting and benefiting from FDI. The initial challenge, from the demand side, is to overcome the small domestic market and limited purchasing power that may discourage certain market-seeking FDI. Solutions to this include emphasizing other features of the economy, such as natural resources, human skills or geographic location. Market size can also be expanded through policies that seek to increase access to foreign export markets. Estonia and Jamaica, through a combination of these tools, have managed to attract remarkably high levels of FDI.

**Figure I.2. Jamaica – FDI inflows, outflows and inward FDI stock as % of GDP**



Source: UNCTAD, FDI/TNC database.

The second challenge is on the supply side and concerns the pressures associated with significant FDI inflows into small markets. Labour, skills and infrastructure shortages must be addressed in order to maintain investment attractiveness. An important finding identified in the case studies was that both Estonia and Jamaica did not identify and anticipate some supply-side challenges, nor did they necessarily address these issues in an optimal way. Consequently, while the case studies demonstrate model practices in many areas, important lessons are also derived from policy shortcomings.

Third is the challenge of designing policies that maximize the contributions of FDI to economic growth. Conventionally, FDI brings with it benefits including capital, employment and

technology. This commonly leads to the introduction of new management practices, improvements in product and services quality, cost and innovation, and leads to positive impacts on productivity and wage levels. These can be categorized as either direct or indirect contributions.

Direct contributions refer to (a) FDI effects on capital formation; (b) trade and the balance of payments; (c) employment and human resource development; (d) technology and innovation; and (e) market structure and expansion. On the other hand, small countries must be aware of the potential for dominant foreign enterprises to negatively affect the balance of payments, “crowd-out” local firms, or engage in anti-competitive behaviour. In their own right, Estonia and Jamaica have managed to secure significant direct benefits from FDI in their economies, although they have not entirely avoided the problems associated with large-scale FDI projects in such small markets.

With respect to indirect contributions of FDI, these can often be more important in the long run. The indirect contributions of FDI to economic growth relate to benefits in the form of spillovers due to close interaction with the local economy. It is in the interest of host countries to encourage foreign affiliates to embed themselves in the local economy and to increase, upgrade, and diversify their operations, including by using the host country as a base for operations in other countries. While these developments are essential for sustaining the competitiveness of the affiliate within the transnational corporation (TNC) group, they make spillovers more likely and are thus crucial to continuing productivity growth and innovation in the host country, and to moving local business activity up the value chain. A key objective is for small economies to progress to what can be described as a “second generation” growth phase, where domestic firms and foreign affiliates generate outward FDI to expand into other markets. It is difficult to assess the extent to which Estonia and Jamaica have benefited from indirect effects.

Although there are strong examples of their occurrence in both cases, there is also evidence of missed opportunities.

In sum, policies to create a positive investment climate for attracting FDI per se are likely to generate certain direct contributions to economic development. However, other dimensions of Government policy have an important role in maximizing the contributions from FDI, especially those of an indirect nature. The following case studies reflect the experiences of Estonia and Jamaica in addressing challenges relating to both FDI attractions and contributions.



## II. POLICIES AND METHODS

### A. Overview of Estonia and Jamaica

*Estonia* became independent in 1991 following the break-up of the Soviet Union. It experienced considerable uncertainty and volatility in the immediate aftermath of the break-up and embarked on policy reforms in 1993. Perhaps taking advantage of the opportunity presented by this disruption, Estonia achieved almost complete investment and trade liberalization very quickly after independence. In *Jamaica*, liberalization began in the 1980s but took place much more slowly against the background of that country's foray into democratic socialism in the 1970s. Jamaica also undertook significant reforms in the early 1990s with substantive trade reform in 1990–1991, and the removal of exchange controls and the adoption of a floating currency in 1991.

#### *Economy*

*Estonia* was under the rule of neighbouring powers for much of the period since the Middle Ages, with brief periods of independence. Following the end of Soviet control in 1991, Estonia experienced a severe transition crisis leading to a 40–50 per cent decline in GDP. It responded with a strong and continuing pro-market reform agenda, supported by a bipartisan political consensus. The rapid reform process involved early price liberalization, full currency convertibility, a legal requirement for a balanced budget, large-scale privatization targeting foreign investors, low taxation and an emphasis on high-quality economic governance.

Rapid economic growth followed the stabilization of the economic environment in the mid-1990s and, by 2002, Estonia regained its 1989 level of GDP per capita. Economic growth *continued* at a remarkably high rate for most of the decade: real GDP growth was 7–8 per cent for 2001–2004, 10–11 per cent in 2005 and 2006, then slowing to 6.3 per cent in 2007 before sliding into recession. Exports also grew strongly between 1993 and 2008. Estonia has been committed to prudent macroeconomic policies,

regional integration and liberal economic institutions, joining the World Trade Organization (WTO) in November 1999 and becoming a member of the European Union (EU) in 2004.

Estonia was quickest among new European Union members to meet the EU's financial convergence criteria. However, the last decade of remarkable growth also led to rapid wage increases, eroding labour cost competitiveness, and to inflation above the threshold set under the EU Maastricht Treaty for the adoption of the euro. Plans to join the Euro Zone within the European Union, initially scheduled for 2006–2007, were delayed until at least 2011. The recent financial crisis has further complicated these plans as Estonia's economy contracted by 3.6 per cent in 2008 and around 13 per cent in 2009. However, the country has maintained a responsible budgetary policy, with a public sector deficit of about 4 per cent of GDP, and the recession appeared to be easing as of late 2009.

*Jamaica* was colonized by Spain and subsequently the United Kingdom, before becoming independent in 1962. Since then, there has been a well-established parliamentary democracy and relative political stability. The post-war boom years of the 1950s and 1960s represented a period of liberal trade and industrial development. In 1972, the new Government took a different approach, promoting self-sufficiency, import substitution and nationalization. The country's experiment with democratic socialism was associated with capital flight, a large exodus of skilled Jamaicans and a decline in tourism. Beginning in the early 1980s, there was a return to a generally liberal economic policy and an emphasis on policy continuity despite changes in Government.

Trade liberalization was instituted following a World Bank Structural Adjustment Agreement in 1983. This led to the removal of all quantitative restrictions and licensing requirements for imports and exports in 1991, as well as tariff reforms. As a result, external market liberalization took place rapidly in the years between 1989

and 1992, with the removal of exchange controls and the adoption of a floating currency (managed float) in 1991. Jamaica was one of the founding members of the Caribbean Community (CARICOM) in 1973 and joined WTO in March 1995. Privatization has taken place over an extended period, and has often involved foreign investors. Between 1987 and 1990, 40 per cent of FDI inflows were due to the sale of State assets, primarily in the hotel sector, which had been largely nationalized in the late 1970s. In addition, there was partial privatization of some banks in the late 1990s and the Government-owned cement company was privatized in 1999. Some infrastructure privatizations to foreign investors have also occurred since then.

Economic growth, however, has been held back by a continuing public debt problem and fiscal deterioration, as well as low productivity in the manufacturing and services sectors. A financial sector crisis in the mid-1990s was a major cause of the huge deficit in public finances, which resulted in national Government debt reaching as high as 135 per cent of GDP. This debt load continues to constrain the Government's policy options. The recent global recession has harmed Jamaica's economy, primarily through a decrease in tourism, reduction in remittances, as well as lower demand for bauxite exports. Real GDP contracted by 1.2 per cent in 2008 and by more than 2 per cent in 2009. The resulting stress on the Government budget exacerbated Jamaica's debt problems, and the country was approved for an International Monetary Fund (IMF) loan of \$1.27 billion in February 2010.

### ***External economic relations and FDI***

Following the break-up of the Soviet Union, *Estonia* pursued rapid integration into global trade and investment flows, beginning first at the regional level. Estonia is one of three Baltic States (the others being Latvia and Lithuania) and has long-standing links with the nearby Nordic countries (Denmark, Finland, Norway and Sweden). Nordic countries together have a population of 25 million with similar historical backgrounds and political systems.

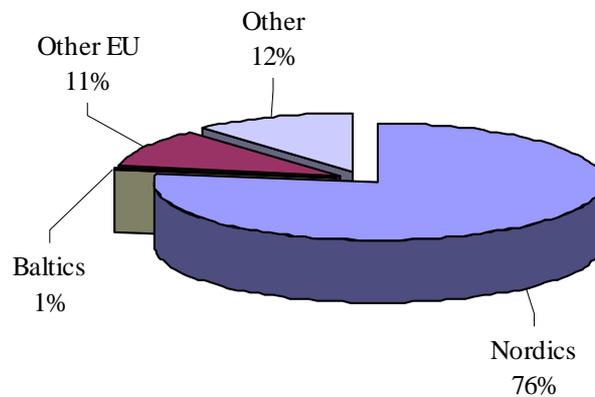
The seven countries together make up the Baltic Sea region. Although Estonia's external economic relations have largely been limited to this area, it has more recently expanded its relationships with other continental EU countries. Internationally integrated sectors of the Estonian economy include real estate, wholesale and retail trade, and especially banking and manufacturing, where foreign companies are dominant.

*FDI flows:* Since the 1970s, Estonian enterprises – although then part of the Soviet Union – have been able to export directly to foreign markets, and from the 1980s they were permitted to form joint ventures with Western firms. Estonia's Nordic neighbours were an obvious target for both FDI inflows and trade links, and these economic relationships became dominant in the years following independence. Since the early 1990s, and especially as of the 2000s, Estonia has seen a significant rise in inward FDI (figure I.1). Annual outward FDI flows over these periods have been modest, but began to expand more rapidly from 2005-2008. In terms of source regions, Nordic countries supplied 76 per cent of Estonia's FDI inflows between 1994 and 2008, with the Baltic States adding another one per cent (figure II.1). Other EU countries accounted for 11 per cent, having significantly increased their share from only 3 per cent in 2006.

*FDI characteristics:* Since liberalization in the early 1990s, inflows of FDI to Estonia have primarily gone to the financial sector, although other important sectors in terms of capital value include wholesale and retail trade, real estate activities, manufacturing, and transportation services. The manufacturing sector drew a significant share of early FDI (figure II.2), and was often associated with the country's privatization programme, which had largely ended by 1996–1997. Wholesale and retail trade was also an important sector during these years, as the economy stabilized and purchasing power rose. A banking crisis in 1998 led

to a string of domestic mergers and acquisitions (M&As), with some of the resulting larger banks purchased by foreign investors.

**Figure II.1. Estonia – FDI inflows by region of origin (1994–2008)**

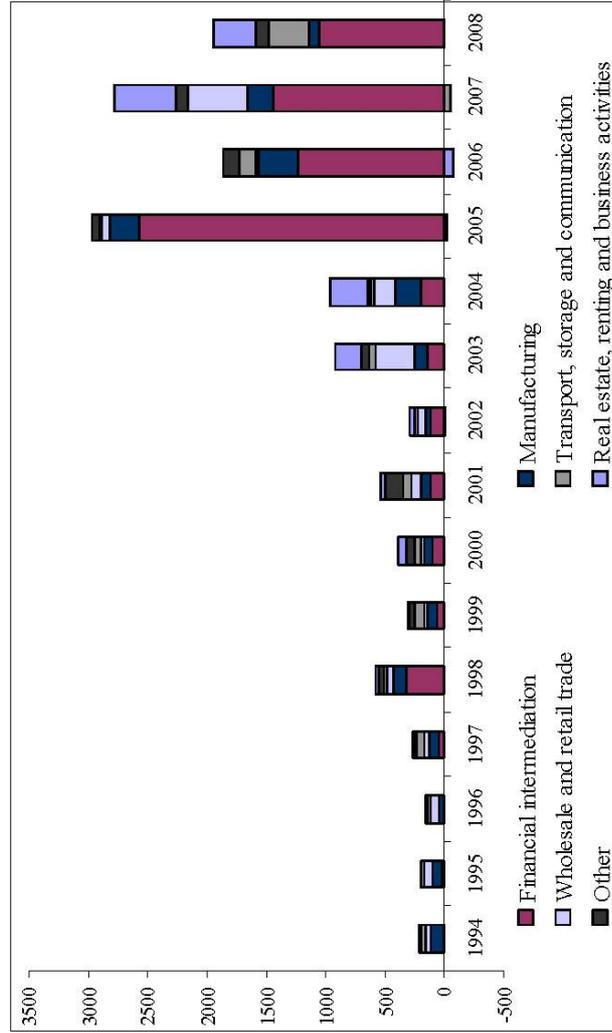


*Source:* Bank of Estonia.

In the early 2000s, FDI inflows in wholesale and retail trade, as well as real estate activities, became increasingly important. From 2003 onwards, Estonia gained from a regional relocation of manufacturing production, but increased costs and labour shortages have limited this trend. As of 2005, there have been massive inflows of financial FDI, mostly due to the expansion of foreign banks that entered the market in the late 1990s. Since the same year, more than two-thirds of Estonia's inward FDI has been in the financial services, real estate and business services sectors. There have also been several major investments in transport, storage and communication. In general, FDI in Estonia has proven quite profitable, with reinvested earnings having constituted the majority of inward FDI since 2002.

Figure II.2. Sectoral distribution of inward FDI in Estonia

(\$ million)



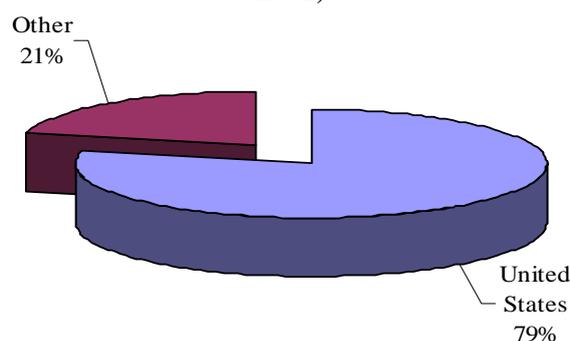
Source: Bank of Estonia.

Interestingly, as with inward FDI, financial services, real estate and business services are also very prominent in Estonia's outward FDI position. This similarity in inward and outward FDI patterns is reflected in the close relationship between inward and outward FDI at the company level. The top five companies in Estonia (ranked according to their inward investment) recently accounted for almost half of Estonia's gross outward direct investment position.<sup>1</sup>

*Jamaica* enjoys a strategic geographic position in close proximity to large markets in the Americas, as well as to Europe via the country's colonial links with the United Kingdom. While Jamaica also has a long tradition of emigration, this has been exacerbated by economic stagnation and the domestic crime rate. The World Bank estimates that remittances from Jamaicans abroad grew to \$2.18 billion by 2008, representing around 15 per cent of GDP. The Jamaican diaspora represents a huge network, the benefits of which extend well beyond remittances to include, for example, services exports in tourism, sports and music. In most recent years, the economy's international integration is underpinned by tourism, alumina and remittances, which dominate capital inflows and exports.

*FDI flows:* Jamaica's inward FDI flows were small until the early 1990s, but since then have grown significantly (figure I.2). The United States has been by far the largest source of Jamaica's inward FDI (accounting for nearly 80 per cent of inflows from 1991 to 2002) (figure II.3). The backdrop is, however, a poorly performing economy with low growth and a weak manufacturing sector. FDI outflows exceeded inflows in the early years of the 1980s, in part a continuation of the capital flight experienced in the 1970s. Subsequent modest outflows are primarily associated with the internationalization of a number of competitive Jamaican-owned enterprises.

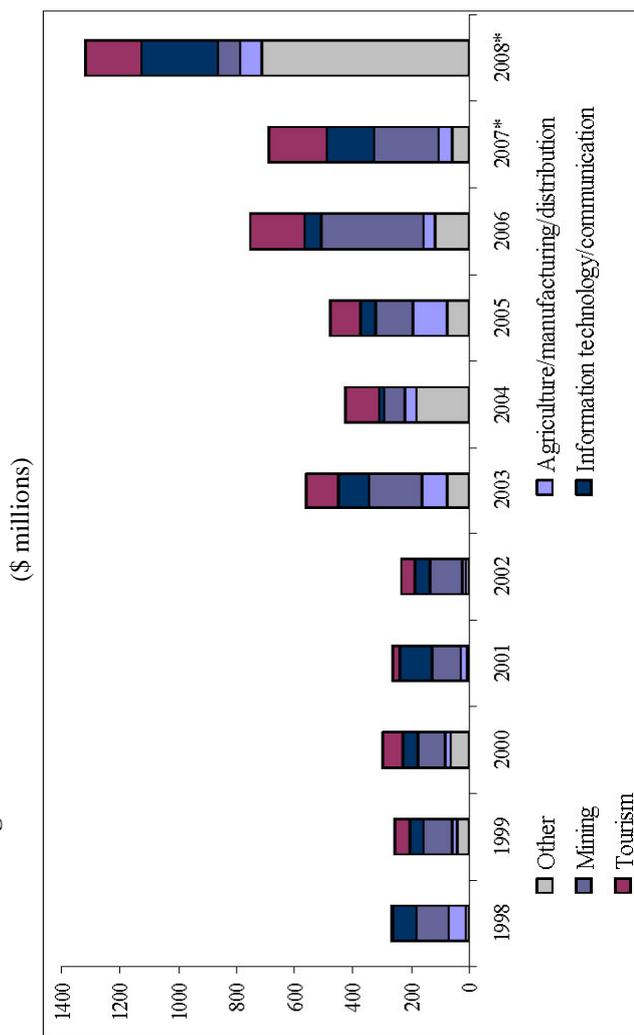
**Figure II.3. Jamaica – FDI inflows by region of origin (1991-2002)**



Source: UNCTAD, WID.

*FDI characteristics:* Since as early as the 1960s, FDI inflows to Jamaica have primarily gone into the mining (mostly bauxite) and tourism industries. From 1998 to 2008, these industries were the first and second largest recipients of FDI and, when considered together with the growing information and communication technology (ICT) sector, typically account for the majority of Jamaica's annual inflows (excluding retained earnings) (figure II.4). Recent investments in mining have been associated with the expansion of local processing capacity to refine bauxite into alumina. The tourism sector has continued its role as a major destination of FDI to Jamaica, much of which driven by investment in large-scale hotels and all-inclusive resorts. An increasingly important sector in recent years has been ICT, where foreign investors have set up call centres and, more recently, software development facilities. Moreover, several foreign investments have been made in the telecommunications network. In recent years, some limited FDI has also gone into agriculture and manufacturing (especially in 2003 and 2005, for example), although these remain small in relative terms.

Figure II.4. Sectoral distribution of inward FDI in Jamaica



Source: Bank of Jamaica, (<http://www.boj.org.jm>).

\* Preliminary.

Although reinvested earnings made up over a third of total FDI inflows in the late 1990s, a dramatic increase in equity investments, combined with consistent repatriation of profits, has since significantly lowered the role of reinvested earnings, which made up only 8 per cent of total inflows in 2008.

## **B. Attracting FDI to small economies**

Small countries must carefully assess and leverage assets that are most likely to attract inward FDI. Due to what was conceptualized above as “demand” constraints, these countries often cannot compete with large economies for many market-seeking or scale-oriented foreign investments. However, with the right policies, small countries can still capture investors’ interest. In addition to standard determinants of investment attractiveness, these countries need to focus on expanding market size through regional and international arrangements. Another potential strategy is the promotion of location-specific advantages, such as natural resources abundance or tourism assets, or a set of fiscal incentives. This section reviews policies pursued by Estonia and Jamaica with respect to FDI policy, business climate, macroeconomic stability and access to international markets.

### ***FDI policy***

In *Estonia*, FDI had a central role in the formulation of Government objectives designed to stabilize and reorient the economy following the country’s separation from the Soviet Union. FDI was seen as important for the immediate objectives of earning foreign currency for much needed imports, obtaining information on foreign markets, compensating for the loss of the Soviet market, finding new ways to utilize existing production potential and gaining access to foreign technology. Privatization was a key vehicle for channelling FDI inflows to meet these objectives. FDI was an integral component of a liberal free market approach implemented over a very short period of time, and was also seen as

playing a key role in longer-term economic growth and development.

Equal treatment of foreign and domestic investors and unrestricted repatriation of profits have been overarching principles in Estonian policy. The 1991 Law on Foreign Investments was one of the first pieces of legislation of the independent nation. It aimed to reassure investors and create an attractive investment climate. Since then, foreign investors have been free to invest in any areas of business open to the private sector and take up to 100 per cent ownership. Some earlier requirements for investment licensing have been replaced by “activity” licensing, applied on a non-discriminatory basis. National treatment has become such a cornerstone of Estonia’s economic and political philosophy that the law on foreign investments was repealed in 2001. Business establishment measures are now dealt with by the Commercial Code of 1995. In effect, Estonia has substantially reduced its legislative capacity to restrict or apply conditions on FDI entry. Current exceptions to national treatment relate only to real estate. Licences are required in mining; energy, gas and water supply; railroad and transport; waterways, ports and dams; and telecommunications. These procedures are applied to foreign and national investors alike on a non-discriminatory basis. Openness to FDI extends to privatization, and only a small number of enterprises remain state-owned: the main port, power plants, the postal system and the national lottery.

Estonia has moved quickly to entrench international standards of treatment and protection of FDI by signing bilateral investment treaties (BITs) with its main partners early in the reform process. Four years after independence, 16 BITs had been signed, including with major future FDI source countries such as Sweden (1992), Norway (1992) and Finland (1992). According to UNCTAD, there were 23 BITs in force as of 2009.

*Jamaica* has historically been open to FDI and has integrated it into its greater economic policy objectives. However, until the late 1980s, foreign investment was governed by a somewhat restrictive regime. Major liberalization began to occur in the late 1980s and early 1990s. The Foreign Exchange Control Act was repealed in 1991, facilitating the repatriation of profits. Around the same time, the list of “prohibited sectors” for foreign firms was abolished, and investors were effectively granted national treatment. Moreover, Jamaica began to aggressively pursue BITs, signing its first one with the United Kingdom in 1987, followed up by another eight by 1994. As of 2009, Jamaica was party to 16 BITs, including with the United States, China, Germany and Netherlands, among others.

Foreign investment was also affected by the National Industrial Policy (NIP), a major integrated policy programme launched in 1996 (Government of Jamaica, 1996). The NIP’s focus included investment in targeted areas of competitive advantage, a push for expansion and diversification of exports, and an increase in the overall rate of investment and savings. It identified growth opportunities in natural resource-based primary products (e.g. bauxite/alumina) and tourism, but in the longer term aimed to diversify the economy into high-skill and high-productivity activities. Five industrial clusters were targeted: tourism, entertainment and sports; telecommunications and ICT; agriculture and manufacturing; apparel and light manufacturing; and minerals and chemicals. These sectors have been key destinations for FDI inflows. Despite setbacks experienced by the programme,<sup>2</sup> the basic principles of an open market economy and of the need for a small country like Jamaica to embrace globalization have subsequently been shown to be an important legacy of the NIP.

In *Estonia*, there has been no formal targeting of FDI, except for privatization of State-owned enterprises, which was an important starting point in FDI attraction in the early 1990s. While

the Ministry of Economic Affairs and Communications handled early business contacts, Enterprise Estonia was established as a separate body in 2000 to promote general business and regional development. The Estonian Investment and Trade Agency operates within Enterprise Estonia to promote trade and FDI. The agency currently operates 10 small foreign offices to help overcome the inevitable low profile of a small country in the investment community. For FDI projects, the agency now offers assistance for negotiations with other agencies and facilitates university linkages, as well as cluster and supply-chain development at a post-investment stage.

*Jamaica*, on the other hand, has a history of formally promoting FDI, targeting sectors and granting investment incentives. Jamaica Trade and Invest (JTI) has been the main organization promoting and facilitating both investment and trade. It currently employs around 80 people, of whom 15 work on FDI-related activities. Overall, JTI handles around 35–40 per cent of prospective foreign investment into Jamaica. Projects in bauxite, airports and some tourism attractions are handled by other Ministries. In addition, some investors can bypass both JTI and the Ministries, seeking approval directly from the Prime Minister, while other investors use the banks to handle investment facilitation. A general criticism levelled at JTI has been the long timeframe for investment approvals, variously quoted as between 6 and 12 months, followed by calls for the establishment of a “one-stop shop” to improve turnaround times. Major JTI successes in recent years relate to the growth of FDI in tourism, particularly associated with a number of major Spanish hotel projects and ICT investments (principally call centres).

### *Business climate*

Providing an attractive operating environment for business has been a foundation of *Estonian* policy since early on. Key features have included (a) observance of private property rights and *intellectual* property rights; (b) an independent judiciary; (c) regulations and penalties to combat corruption; and (d) transparent policies to foster competition, although instances of favouritism still “are not uncommon”. Estonia’s 1993 competition law did not have merger control provisions, but since 2001 it has been harmonized with the EU legislation. After many organizational changes, a well-staffed Competition Authority now oversees regulated industries. A Financial Services Authority was also established in 2001 under the auspices of the Central Bank to undertake financial supervision on behalf of, but independent of, the Government. These initiatives are especially important given that Estonia’s small market size presents competition issues, particularly in areas such as banking, where a small number of foreign-owned firms make up the vast majority of activities.

Estonia’s efforts to develop a regulatory environment that protects the public interest, while remaining conducive to business, have been recognized by many international rankings on business climate. For example, the country was ranked 35<sup>th</sup> out of 133 countries in the 2009–2010 World Economic Forum Global Competitiveness Rankings, and 27<sup>th</sup> out of 180 countries in the 2009 Transparency International Corruption Perceptions Index. From 1996–2008, Estonia improved on nearly all of the World Bank Governance Indicators (table II.1). Most recently, Estonia ranked 24<sup>th</sup> out of 183 economies in the World Bank’s “Doing Business 2010” listing. The range on specific business topics was large, however, from ranking 161<sup>st</sup> on “employing workers” to ranking third on “trading across borders”. This disparity reflects some inflexibility in labour regulations, but great success in facilitating trade relationships with regional and EU partners.

**Table II.1. Estonia's and Jamaica's Percentile Rank on Governance Indicators**

Governance indicator	Estonia		Jamaica	
	1996	2008	1996	2008
Voice and accountability	75.6	83.2	69.9	66.3
Political stability	61.1	67.0	45.2	34.9
Government effectiveness	73.9	84.8	43.1	57.8
Regulatory quality	96.6	91.8	71.2	63.8
Rule of law	66.2	84.7	42.9	39.2
Control of corruption	55.8	79.2	38.8	35.7

*Source:* World Bank, Governance Matters VIII, 2009, Governance Indicators.

*Note:* Indicates rank of Estonia and Jamaica among all countries in the world.

Unlike most other Central and Eastern European countries, Estonia has not offered any incentives specific to foreign investors. In 2000, however, a new tax regime was introduced which applies zero corporate taxation until profits are distributed. Upon distribution, the underlying profits are taxed at 21 per cent. This provision offers a stimulus to investment and capital accumulation, and likely accounts for the large share of retained earnings in total FDI inflows. As a consequence, this approach may have encouraged TNCs to use their affiliates in Estonia as a base for outward FDI. Foreign affiliates' profits made in Estonia would be free of tax if invested abroad rather than distributed as dividends, which is helpful in facilitating outward FDI through foreign affiliates in Estonia. There are also four customs-free zones near Estonian ports and inland, with duty-free status for imports and re-exports. Most of these zones will not be allowed to function beyond March 2011.

Evaluations of the regulatory and business environment in *Jamaica* show a mixed picture. Key challenges relate to governance, crime and violence, and taxation. Governance problems lead to lengthy and cumbersome procedures. One study indicated that

entrepreneurs have to make 72 payments and spend 414 hours to pay taxes. Similarly, it takes 18 steps and 202 days to implement business contracts, an issue which is paralleled in the lengthy period required to facilitate FDI projects (World Bank, 2005b). Jamaica's ranking on some key World Bank Governance Indicators has dropped since 1996, including on "regulatory quality" (table II.1). Research for this study indicated some improvement in respect of business establishment time and processes. The slow pace of settlement through the judicial system was acknowledged, but the independence of the judiciary had improved significantly. Intellectual property rights (IPR) protection, although weak until recently, is seen to have improved, partly due to domestic concerns over protection of the country brand (particularly ownership of the reggae music brand).

Problems of crime and violence are pervasive across the Caribbean, with the murder rates and assaults well above world average. A report by the World Bank and the United Nations Office on Drugs and Crime (2007) estimated that reducing the region's murder rate by one-third could more than double the Caribbean's per capita economic growth rate. A different World Bank (2003) report estimated that rampant crime costs Jamaica at least four per cent of its GDP, including lost production, health expenses and spending on security. The report goes on to note that the high crime rate also encourages migration, especially among the more educated and internationally mobile population.

The costs of crime are real for business. For exporting firms, security costs may reach five per cent of sales. Small firms' losses from various forms of crime may be up to nine per cent of revenues with an average of three to six per cent for firms in manufacturing and distribution (World Bank, 2003). From an FDI perspective, the issue goes beyond costs for established foreign investors. TNCs may simply eliminate Jamaica as a potential location during their screening process because of concerns about crime and violence.

One response to these issues has been to carve out investment packages that offer better conditions than the general environment (JTI, 2007). This approach is evidenced in Jamaica's use of tax incentives and the creation of free zones with streamlined procedures. Jamaica has applied a wide range of incentive schemes, including tax concessions and duty-free access for imports of inputs and capital goods. Some schemes are geared at promoting exports (e.g. Export Industry Encouragement Act and Foreign Sales Act); others apply to all industry (Modernization of Industry Programme); while others are industry-specific (e.g. Bauxite Encouragement Act). Box II.1 illustrates the Hotel Incentives Act that helps promote FDI in the tourist industry.

#### **Box II.1. Incentives in the tourism sector in Jamaica**

Tourism is a critically important sector in Jamaica. As a labour-intensive industry directly employing about 85,000 people (9 per cent of the labour force) in a fragile economy, tourism has a significant role in poverty alleviation; it is also a major source of foreign exchange, estimated at \$1 billion in 2000. The Caribbean is the most tourism-dependent region in the world. Jamaica ranked fifth in number of arrivals in 2004 after the Dominican Republic, Cuba, The Bahamas and Puerto Rico, or second within CARICOM.

The strategy for tourism FDI as implemented by JTI focused on hotels and attractions. The Hotel Incentives Act offers income tax and duty concessions of up to 15 years for hotels with at least 350 bedrooms and 10 years for smaller hotels. An Attractions Package launched in 2003 provides for the importation of specific items free of consumption tax and customs duty for a period of five years, in addition to a five-year exemption from corporate taxes. This package is designed to enhance tourist spending within the country. The two incentive packages may be somewhat at odds with each other, since the large hotel complexes are commonly "all inclusive" with a single cost.

/...

**Box II.1 (concluded)**

There have been major successes in attracting very large Spanish hotel complexes, a strategy pursued by JTI to diversify the tourism base from United States visitors. The first of these investors was Riu Hotels in 2000 with over 400 bedrooms, followed by other Spanish hotel investments. Significant FDI projects have also begun in the attractions sector, such as the Dolphin Cove facility. The National Planning Summit 2007 proposed a grand plan for the Montego Bay area, envisioning the creation of a business, shopping and entertainment playground for the Americas.

*Source:* World Bank, 2003; Clayton and Karagiannis, 2007; Government of Jamaica *et al.*, 2007.

Fiscal and export-based incentives are also offered to export-oriented industries in the country's free zones (FZ). Under the Jamaican Free Zones Act of 1982, aside from duty-free importation, the major incentives are tax holidays. Initially, a 100 per cent tax holiday was offered in perpetuity, but the tax break is now only available until 2012. In 1996, the Act was amended so that firms outside the FZ complex could benefit from a single entity FZ status. Historically, garment manufacture was the main FZ activity, but now the Cazoumar Zone, for example, specializes in ICT operations. In addition to fiscal incentives, Jamaica also provides loans with concessionary financing to investors.

As is common in many host countries, some local companies feel that foreign investors are getting a better deal. However, the guiding principle of the incentive regime is non-discrimination between local and foreign investors, except in offshore banking, which is reserved to 95 per cent foreign-owned firms. Interviews revealed an acceptance of the inevitability of incentives until other conditions in the country improve (e.g. crime and the costs of protecting personnel and property). Several interviewees commented that, in a small country such as Jamaica,

“companies dictate the incentive package”, creating conditions of “economic capture”. It was suggested that the incentive system was probably outdated, and that an overhaul of the tax system would provide better incentives to investors.<sup>3</sup>

### *Macroeconomic environment*

Consistent with the country’s overall policy stance, *Estonia* has emphasized basic macroeconomic stability. Inflation in the early transition period has been brought under control. Government debt has been negligible, primarily because maintaining a balanced budget on an annual basis has been the norm since the early 1990s. Despite a prudent approach to financial management, however, the country recently encountered serious problems. The policy of maintaining a fixed exchange rate pegged to the Euro kept interest rates low despite fast income growth and rising inflation, decreasing Estonia’s competitiveness. The trade deficit worsened from 10 to 18 per cent of GDP between 2005 and 2008.

To cover this deficit, loans were available on the private capital market, largely through intra-group borrowing from foreign parent banks of local branches. This trend weakened the net foreign asset position of Estonian affiliates and increased external financial stability risks. Loans denominated in foreign currencies exceeded 80 per cent of all private loans and were 95 per cent at flexible rates. This financing permitted excessive domestic consumption, driven primarily by a housing investment boom fuelled by high expected income growth and accommodated by tax incentives and cheap credit from foreign loans. When the global financial crisis hit, access to capital dried up and domestic demand collapsed, throwing the economy into recession. Still, Estonia’s responsible management of fiscal policy maintained a high credit rating. In fact, the Government announced in October 2009 that it would pay back early a Euro 50 million loan it had obtained from Swedbank in May. Improved coordination in supervising cross-border financial groups among the Nordic countries is also being explored.

In *Jamaica*, macroeconomic conditions have not been as supportive of FDI attraction. Growth has been low in the period under study (see key facts table). Inflation has been reduced, but has often exceeded 10 per cent. The major problem has been and remains the very high level of public debt, deriving partly from the financial crisis of the late 1990s and the decision of the Jamaican Government to prop up illiquid banks and provide an implicit 100 per cent protection to depositors. Public debt levels led to significant declines in the manufacturing sector, both domestic- and foreign-owned: high interest rates (derived from the high level of internally funded Government debt) constrained domestic borrowing and led to an appreciation of the real exchange rate and declines in both manufacturing exports and manufacturing employment from the mid-1990s (Bloom *et al.*, 2001; World Bank, 2003).

According to World Bank figures, Jamaica's public debt as a share of GDP has been consistently above 100 per cent since 2001. Consequently, high fiscal surpluses are required simply to balance the budget and avoid increasing debt levels.<sup>4</sup> Nearly 60 per cent of the national budget currently goes to debt servicing and recurrent expenditures, leaving little to fund social and physical infrastructure needs. To compound the problems, public sector wages and salaries presently amount to 10–12 per cent of GDP, which is higher than many comparable countries in the Caribbean and Latin America. The outcome has been a crowding out of capital expenditures which declined substantially, thereby also hampering the Government's ability to invest in infrastructure and public goods (IDB, 2006).

The recent global economic crisis added further complications, particularly when the United States recession led to a decrease in demand, especially in the tourism sector, and reduced by 10–13 per cent Jamaica's substantial remittances from overseas. Recessionary conditions also decreased global demand and prices for commodities, leading to the closure of several bauxite mines and alumina refineries, further reducing Jamaica's export, tax, and foreign exchange earnings. As of late 2009, concerns over the

Jamaican Government's ability to meet its debt payments led major rating agencies to downgrade the country's sovereign credit rating. The Government has since been approved for an IMF loan in order to meet its obligations.

*Externalization policy – liberalization and trade*

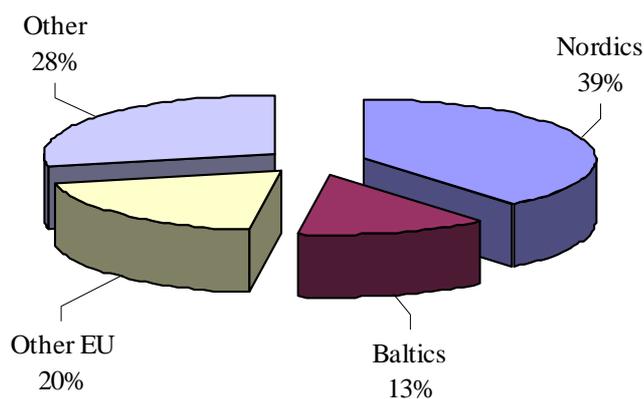
With the reconstitution of the Republic of *Estonia* in 1991, virtually the entire policy and legislative framework of the country had to be re-created. There have been four prongs to external trade and investment policy: unilateral – abolition of tariff and non-tariff barriers; bilateral – trade and investment agreements with major trading partners; regional – EU membership; and multilateral – membership in WTO.

Estonia moved very rapidly to sign free trade agreements (FTAs) with larger neighbours and with more advanced economies. FTAs with Sweden and Norway were signed by 1993, and an agreement with the European Union was signed in 1995. Estonia did not seek to form a regional trade arrangement with the other Baltic States, yet given Estonia's ties in the Baltic Sea region, it was inevitable that its policy would focus on this area. Other major trade policy developments include membership in WTO in 1999, and accession to the European Union in 2004.

FDI inflows into Estonia appear largely related to initial trade integration with Nordic countries in the 1990s, as well as the regionalization of financial and manufacturing industries in the 2000s. Since 1995, Estonia's Nordic and Baltic neighbours have been the destination for more than one half of Estonia's goods exports (figure II.5). This is unsurprising given the role of the Nordic countries in supplying three quarters of Estonia's FDI inflows. The EU membership and the prospect of accession to the euro zone have likely played a role in securing further inflows of foreign capital to Estonia. This prospect provided investors with an additional guarantee in terms of the future stability of the Estonian

economic environment and simplified customs procedures, thereby speeding up trade with the other EU member States, which represent 20 per cent of Estonia's goods exports. On the other hand, the effect of EU membership on FDI inflows is difficult to distinguish from the much broader trend towards global relocation of economic activities (Copenhagen Economics, 2006). By 2005, around half of Estonian composite exports to Finland, Sweden, Denmark and Germany involved intra-industry trade, that is, the re-export of imported raw materials and intermediate products after processing in Estonia (Tiits, 2007).

**Figure II.5. Estonia's goods exports by region of destination (1995–2008)**



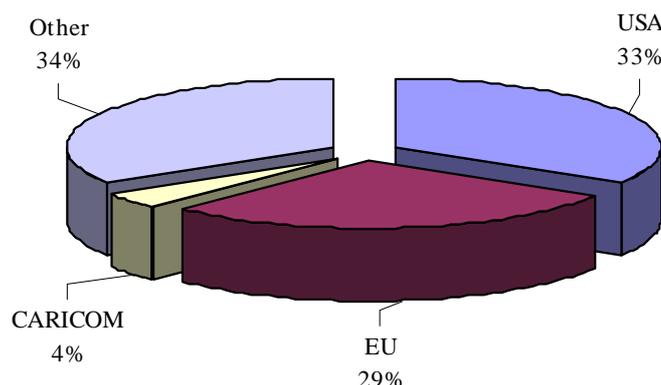
Source: UNCTAD, WITS Database.

In *Jamaica*, external liberalization took place rapidly between 1989 and 1992. Exchange controls were removed and the currency floated in 1991. By contrast, the trade liberalization process took nearly two decades up to membership of the WTO in 1995. Jamaica is now an open economy with low tariffs and generally few barriers to trade (except in traditional agricultural sectors).

As shown in figure II.6, almost two thirds of Jamaica's goods exports are split between the United States and EU markets, with the remainder going to other regions. Jamaica was a beneficiary of the United States Caribbean Basin Special Access Programme for Apparel, which gave duty concessions for locally-assembled garments of United States-made materials. While important in the past, the signing of the North American Free Trade Agreement (NAFTA) adversely affected exports of apparel from Jamaica and the programme has become much less significant for exports to the United States (USITC, 2007). Jamaica has historically benefited from preferential access to European markets through the Lomé Conventions and the more recent Cotonou Agreement, particularly in various agricultural sectors.

By contrast, the CARICOM region absorbs only four per cent of Jamaican exports. CARICOM was set up in 1973 to establish a common external tariff (CET) on non-community imports, alongside modest coordination initiatives.<sup>5</sup> Despite the CET, rules allow for "suspensions", thereby maintaining fragmentation within a small grouping in a global context. To date, the progress and contribution of regional integration in the Caribbean has been slow and limited. The market is still small, not only because of small populations, but also limited purchasing power in some countries; and large TNCs from CARICOM countries have outgrown the Caribbean region. In general, regional integration to date has not stimulated FDI because the overall market remains small and fragmented, and thus access to the United States and EU markets has been the cornerstone of Jamaica's efforts to increase its effective market size for foreign investors. Indeed, the reliance on foreign markets by CARICOM is highlighted by the recent signing of an economic partnership agreement between the regional institution and the European Union.

**Figure II.6. Jamaica's goods exports by region of destination (1991–2008)**



Source: UNCTAD, WITS Database.

### C. Maintaining FDI inflows

Successfully attracting FDI in order to export to world markets can quickly lead to supply-side constraints in a small domestic economy. This effect may be manifested in labour and skills shortages, as well as infrastructure bottlenecks. As illustrated by the cases of Estonia and Jamaica, the speed and extent of these constraints are difficult to anticipate and address in small countries. Pro-active education, immigration and infrastructure policy are key strategies to alleviate these limitations.

#### *Labour and skills policy*

*Estonia's* earlier labour cost advantage, which may have helped drive FDI in manufacturing in the early 2000s, has eroded in face of annual wage increases of 10–15 per cent. Most FDI was traditionally directed to the capital, Tallinn, where these increases were most prominent. The ratio of labour costs to productivity in Estonia is now similar to the average of the enlarged European Union. Some efficiency-seeking FDI has thus started to shift to

lower cost locations outside the country. The closure or relocation of economic activities that are no longer cost competitive in Estonia has begun triggering adjustments in the country's economic structure.

A survey of foreign investors undertaken by Enterprise Estonia (2006) confirmed the problem of labour and skills. Investors identified a lack of qualified labour as the number one problem, as well as issues such as weaknesses in the continuing education system, the quality of existing labour, and insufficient vocational training. Although Estonia outperforms both the OECD and the European Union on secondary and tertiary educational attainment (table II.2), the total number of new graduates in 2007 in all fields was only 12,612 according to UNESCO. Interviews revealed that the lack of a critical mass of specialized skilled workers made it difficult to attract large TNC outsourcing services in research and development (R&D) and software design operations. Ultimately, the limited pool of labour makes it difficult to develop highly specialized skills sets (in one example, Estonian accountants tend to provide both general and international tax advice). These skill constraints have increasingly become a barrier to the attraction of higher value-added FDI.

**Table II.2. Education in Estonia**

	Population with at least upper secondary education (%)	Population with tertiary education (%)
Denmark	75	32
Finland	81	36
Iceland	65	30
Norway	79	34
Sweden	85	31
Estonia	89	33
OECD average	70	28
EU 19 average	71	24

*Source:* OECD.

*Note:* Age group 25-64.

Migration flows and policies in Estonia have not made up for the gap between the supply of labour and skills and the demand for these resources from foreign investors. According to UNCTAD, net migration rates in Estonia were negative in the early and mid-1990s, mostly due to emigration to the Russian Federation after the fall of the Soviet Union. Since then, however, net migration rates for 2000–2010 (realized and projected) have been neutral or slightly positive. In general, Estonia lacks a pro-active immigration policy that could help address the shortage of labour and skills. There appears to be a negative stance towards immigration, with lengthy and complex procedures.

Estonia's problems with labour supply may also be related to regulatory barriers. As mentioned earlier, in 2009, the World Bank ranked Estonia 161<sup>st</sup> with respect to the ease of "employing workers" (World Bank, 2009). Identified problems include significant limitations on the use of fixed-term contracts, several restrictions on working hours as well as complications and costs related to redundancies. These barriers to hiring and firing may reduce the availability and mobility of Estonia's existing labour stock, and thus exacerbate the supply constraints facing foreign investors.

Historically, *Jamaica* has made a strong commitment to education but there is a mixed record on the availability of highly skilled people. Public spending on education has remained relatively low (four per cent of GDP in 2004 and seven per cent in 2007), yet this remains above the average among Latin American and the Caribbean countries (four per cent of GDP in 2004 and 2006). Moreover, this spending does not seem to have proportionately translated into a more educated population.

For example, enrolment at primary and secondary schools has been relatively high according to World Bank figures, but there are concerns about the quality of education as evidenced in

consistently high illiteracy rates (20 per cent of the population in 1999). Although tertiary enrolment rates have been rising, they continue to lag behind the regional average. The University of the West Indies and the University of Technology have excellent reputations, but there has been widespread criticism of the performance of university graduates.<sup>6</sup> At the micro-level, the latter is reflected in concerns of ICT professionals about the qualifications of university-trained programmers. Moreover, the lack of Spanish-English bilingualism limits wider opportunities in the ICT sector. Although job training is used to customize education and training to sector and company requirements (Jamaica has a three per cent payroll tax to fund such training), there are questions as to whether it delivers commensurate benefits.

Overall, the quantity and quality of trained and trainable labour acted as supply-side constraints on Jamaica's competitive position for FDI. Adding to the problem, Jamaica's skill attraction and retention policies have not been sufficient to stem net outward migration. Since at least 1990, there has been a significant and constant net outflow of labour (an average of 20,000 per year from 1990 to 2005), a large share of which are skilled workers, and there are no signs of a reduction in the near future. Although remittances make up for lost tax revenues, the outflow of skilled labour continues to be a major drain on Jamaica's small economy, thus limiting its attractiveness as a destination for foreign investment.

### *Infrastructure policy*

*Estonia* regained independence with an overall reasonable standard of infrastructure, though with some exceptions such as telecommunications. The severe decline in economic activity in the early years took the pressure off demand and requirements for capacity expansion, especially in the backbone areas of business infrastructure such as sea ports, roads, rail and electricity. The road network did not require much expansion in the early to mid-1990s,

growing by only eight per cent from 1991 to 1997. Moreover, according to the World Bank, electricity consumption in 2006 remained below the 1991 level.

However, key infrastructure expansion in Estonia has occurred in areas consequential to attract foreign investors: office facilities, housing, telecommunications, as well as passenger air and sea transport. For example, air passenger numbers expanded by 410 per cent (1993-2007) and the number of fixed and mobile telephone subscriptions rose drastically from 24 per 100 people in 1993, to 225 per 100 people in 2008. Fixed broadband internet connections also rose quickly in recent years. Furthermore, from 1998 to 2005, the road network expanded by 18 per cent. Public infrastructure policy has also been related to the country's privatization programmes:

- *Telecommunications* infrastructure inherited by Estonia in 1991 was in relatively poor condition and privatization was a priority. 49 per cent of fixed and mobile services were sold to Finnish and Swedish telecom companies, and in December 1992, a concession agreement gave the newly established Estonian Telephone Ltd. a monopoly for services until 2000. The small size of the Estonian market was likely a factor in providing such exclusive rights in order to attract a well-capitalized investor. Ending this monopoly position was a condition to joining the European Union.
- *Railways*. In August 2001, the Estonian railway was privatized to a consortium of foreign and local investors. This sale was expected to lead to new investment and efficiency gains. In the following years, however, private owners sought to divest their stakes and a series of negotiations took place with prospective buyers. Finally, in November 2006, the Government of Estonia re-nationalized the railways. In 2007, the transit of Russian oil via Estonia

was reduced, placing renewed pressure on Estonian railways to restructure.

- *Electricity*. Privatization of the electricity infrastructure was delayed until late in the privatization process. In the early 2000s, a subsidiary of United States-owned Enron was very close to finalizing a deal for state-owned Estonian Energy Ltd., the main electricity producer in Estonia. With the bankruptcy of the parent company in the United States, negotiations were ended and Estonian Energy was taken off the privatization list.

Backbone infrastructure services are considered by many foreign investors to be a key determinant of FDI inflows to *Jamaica*. Public-private partnerships have played an important role in expanding this infrastructure, but pure state ownership remains in certain areas. While privatizations were at their height in the late 1980s, there has been renewed interest in recent years.

- *Electricity* was privatized in 2001, with United States-owned Southern Energy Inc. taking an 80 per cent stake. The Government's 20 per cent remaining stake was acquired by Japanese Marubeni. Reliability of power supply has improved compared with the pre-privatization era but, despite a large investment programme, island-wide shutdowns still occur. This continuing unreliability of supply, plus high costs compared to many countries, means that power still represents a constraint to growth. Nonetheless, according to the World Bank, electricity consumption between 1991 and 2006 increased more than three times.
- *Water and sewerage* infrastructure is the responsibility of the National Water Commission, a statutory body established in 1980. A continuing programme to install new

and upgrade existing systems across the island has failed to match demand requirements and there are regular supply disruptions. Very large investments will be needed to meet the needs, for example, of large-scale tourism FDI.

- *Ports.* The publicly-owned Port Authority of Jamaica is regarded as an efficiently-performing enterprise and has regulatory authority for both privately- and publicly-owned ports.
- *Airports.* Privatization via concession agreements has been planned for the two international airports. One such privatization occurred in 2003, when a consortium of foreign investors secured a 30-year concession to operate and manage Sangster International Airport. This airport serves the island's principal tourist location and privatization led to expanded capacity and improvements in service delivery. Privatization of the second airport is still pending. Air Jamaica was privatized in 1994 (75 per cent privately owned) but its viability continues to represent a drain on public resources.

There is particular interest in Jamaica's experience with *telecommunications* and *roads* in a small country context:

- In telecommunications, Jamaica's population of 2.7 million has over 3 million telephones (2.7 million cellular and over 300,000 fixed-line telephones, based on 2008 data). Telephone lines increased from 5 per 100 people in 1991 to 12 per 100 in 2008. Initial privatization occurred in 1988, but there was widespread criticism of the monopoly TNC operator, Cable & Wireless. By contrast, the entry of Irish-owned Digicel in 2001, and broadband company Flow in 2005 (owned by Barbados-based Columbus

Communications), has had a positive impact on access, coverage and costs of telephone services.<sup>7</sup>

- Jamaica has an extensive network of roads for a small island. This network expanded 28 per cent (road length) between 1991 and 2006. Continuing problems exist with the level and cost of maintenance. The *Highway 2000* project, the first toll road in the country, attracted controversy over the level and variability of tolls and the Government subsidy to the French operator. It is questionable whether further toll roads will be built in the near future. The Government's philosophy holds that tolls should not be imposed on roads where the development is funded by taxpayers. Thus, the latest large highway project in the north of the island is not tolled.

Budget constraints incline Jamaica towards seeking private investment to augment backbone infrastructure, especially in power and telecommunications. Yet, the experience of Jamaica also shows the need for high-quality regulation and the benefits of introducing competition where possible.

#### **D. Maximizing contributions from FDI**

In small economies, the direct contributions of a rapid build-up of FDI are immediately evident. Direct FDI contributions can include high levels of capital formation and strong output growth, substantial job creation as well as export expansion and diversification. Indirect contributions of FDI come from raising productivity in the domestic economy through inducing greater competitiveness in local firms and by upgrading the business activities of foreign affiliates themselves.

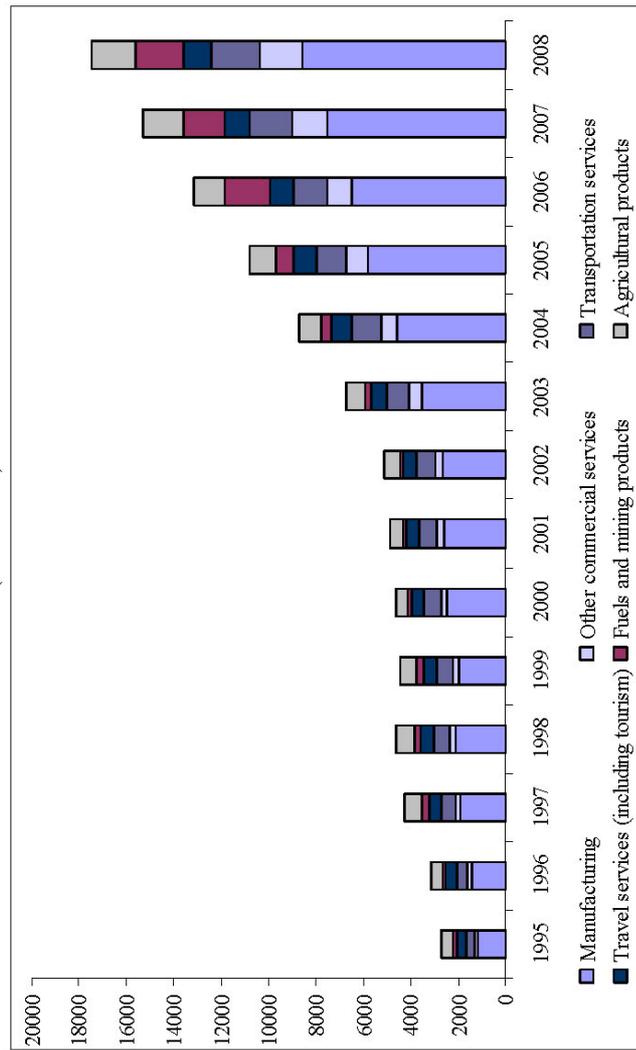
### *Direct contributions*

Although the countries took different approaches with respect to FDI attraction, they both received significant FDI inflows, which set the foundation for direct contributions to the local economy. The most obvious contribution of these inflows has been the impact on capital formation. For example, from 2003 to 2006, FDI inflows made up 40 per cent of Estonia's gross capital formation, compared to an average of 24 per cent for other small developed countries. In Jamaica, from 1998 to 2006, the share was 23 per cent, compared to an average of 19 per cent among small developing countries. In addition to its role in capital formation, this section examines the immediate contributions of FDI to Estonia (Stephan, 2003; Piech and Radošević, 2006) and Jamaica, specifically in terms of exports, employment, research and development, and market structure.

### *Exports*

A significant portion of FDI in *Estonia* has gone into services directed at the domestic market, particularly in the banking sector. However, growing outward FDI from this sector may be associated with rising exports of financial services. Estonia also exports travel (including tourism) and transportation services (figure II.7). Manufacturing exports have grown strongly and have generally made up the majority of total exports. A study on the Estonian manufacturing industry, using data from 1996-2001, showed that foreign affiliates are larger and indeed more export-oriented than domestic firms (Hannula and Tamm, 2001). Inflows of manufacturing FDI in the early to mid-2000s have played a significant role in the rapid rise of exports from this sector in recent years. Other important exports include agricultural goods and fuels and mineral products, although FDI has played a limited role in these sectors.

**Figure II. 7. Estonia's export structure**  
(\$ millions)



Source: WTO Trade Statistics.

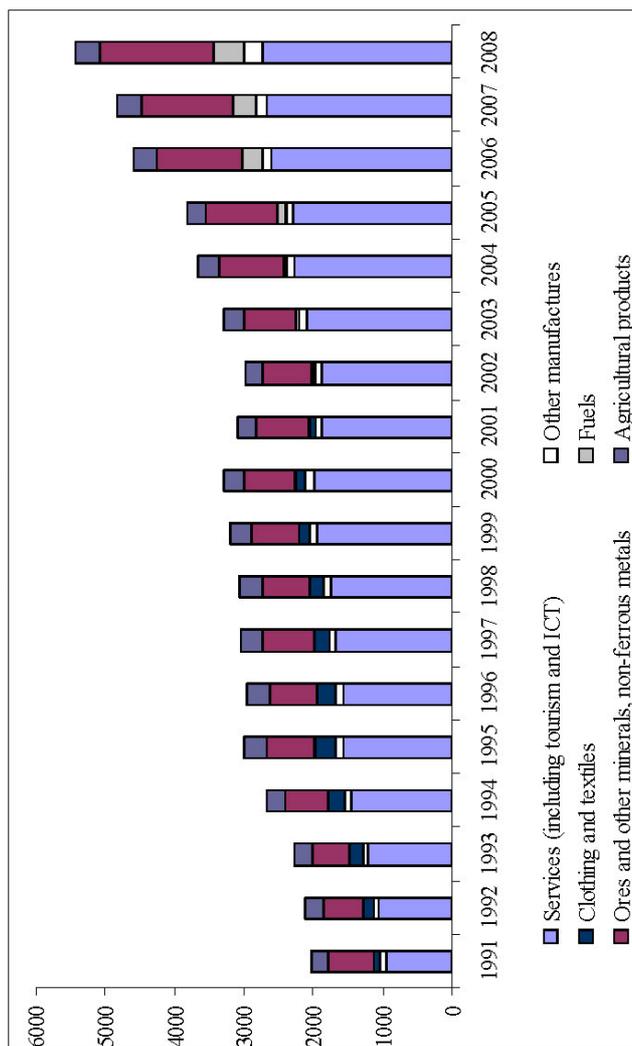
Figure II.8 shows changes in the scale of *Jamaica's* export structure and diversification. FDI has contributed strongly to growth in services exports, particularly with the construction of new hotels and tourism-related services. Tourism revenues make up the bulk of service exports. More recent FDI in the ICT call centres has led to an increase in ICT exports, yet the overall share remains low. These investments helped offset the decline in apparel exports after NAFTA decreased *Jamaica's* competitiveness in those sectors. The important role of bauxite, which has received substantial FDI, and the relatively steady contribution of agriculture are also evident. Exports of fuels have also begun to play a role in recent years.

#### *Employment*

Foreign investment in *Estonia's* manufacturing sector has had a strong employment impact. A study of *Estonia's* manufacturing firms (with 100 or more employees) found that foreign affiliates (comprising 29 per cent of the total number of firms) accounted for 56 per cent of the workforce in manufacturing (Damijan *et al.*, 2003) and were clearly a major support factor during a very difficult period of reorienting manufacturing to Western standards and markets. The respective employment contribution of manufacturing foreign affiliates in Lithuania, Latvia and Poland was much lower. In addition, wage levels in *Estonian* manufacturing affiliates were found to be 40 per cent higher than those paid by domestic firms. While no similar data are available for the services sector, foreign affiliates are also likely to have been significant employers in banking.

Total employment data in *Jamaica* show a 29 per cent increase between 1991 and 2008 (with a population increase of around 14 per cent). While there is no data on the proportion of jobs in foreign affiliates, interviews conducted for this study indicated that TNC affiliates have positive effects on employment levels. Employment gains can be primarily linked to the expansion of the tourism sector. Having attracted significant FDI, tourism contributed nine per cent to the country's total employment

**Figure II. 8. Jamaica's export structure**  
(\$ millions)



Source: WTO Trade Statistics.

*Research and development*

FDI in Estonia has boosted the country's technological intensity. According to the World Bank, high-technology exports as a share of total manufacturing exports rose from 6 per cent in 1995 to a peak of 37 per cent in 2000. Yet, they have fallen since then to an average of around 20 per cent per annum. Estonia's national R&D expenditure has improved as a portion of GDP, increasing from 0.6 per cent to 1.2 per cent of GDP between 1998 and 2006. The private sector's share of GDP has roughly doubled between 2000 and 2007 (although it had been quite low prior to that, perhaps due to a lack of significant tax incentives for business R&D). This increase was likely due to the rise in foreign manufacturing affiliates which, in 1998, accounted for 90 per cent of R&D investment in the sector (Damijan *et al.*, 2003). This figure outweighs significantly the relevant contribution of foreign affiliates in R&D investment in other countries, such as Lithuania, Latvia and Poland.

Although comparable statistics are not available for Jamaica, data for 2002 reveal a very low rate of R&D expenditures, at less than 0.07 per cent of GDP (World Bank). Since then, however, the Government has been encouraging expansion of the ICT sector into software development, which may help raise these figures (box II.2).

**Box II.2. Shifting from apparel to ICT**

Aided by the United States Caribbean Basin Initiative (CBI), FDI in apparel was a big initial success story for the Free Zones initiative in Jamaica. Exports to the United States under the favourable CBI terms rose from \$5 million at the end of the 1970s to \$127 million at the end of the 1980s (King, 2001). Employment in the Kingston Free Zone alone grew from under 500 in 1980 to 10,500 in 1987, nearly all in garments (Watson, 1988), while total employment peaked at 40,000 people. From 1994, NAFTA gave Mexico a strong competitive edge and termination of the

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**Box II.2 (concluded)**

multi-fibre arrangement (MFA) sealed the decline of the industry in Jamaica. Among United States firms which closed or drastically reduced their operations were: Jogtogs (1997); Hanes, a subsidiary of Sara Lee, (April 1998); and Oneita Strathleven (May 1999).<sup>8</sup> Large numbers of jobs were lost in this sector, overwhelmingly women.

Jamaica recognized the need for restructuring in the face of changing global competition in the National Industrial Policy of 1996. Development of Jamaica's ICT sector is an excellent example of the benefits from a policy of rapid adaptation following the decline of the apparel sector. The Free Zones in Montego Bay were prime movers in the Government-driven shift to ICT from the second half of the 1990s (Mugione and Castillo, 2001). However, the principal facilitating factor for FDI in ICT was the liberalization of Jamaica's telecommunications sector. JTI implemented an FDI attraction strategy designed to grow offshore ("nearshore") outsourcing, followed by movement up the value chain towards software development and offshore training, as well as the establishment of Technology Parks with foreign collaboration. There are currently around 23 outsourcing (mainly call centre) companies in Jamaica employing an estimated 14,000 people. Employees are largely women with high school level qualifications. The major companies are listed below in table II.3. ACS, a Dallas-based TNC, is the only company presently undertaking payroll processing. A broad estimate of business process outsourcing (BPO) exports is \$400 million, with 90 per cent to North America.

The software development sector is still in its early stages, but a Software Developers Association is being created to formalize the sector and identify training requirements. Opportunities are expected to encourage diaspora software engineers to return from North American universities to establish new offshore software ventures. Challenges for the industry include shortages of space, the availability of graduates for upgrading activities, telecommunications costs, and the existence of co-location facilities. Crime and corruption do not appear to be significant deterrents for investors, but they avoid potentially dangerous areas like inner city Kingston. If Jamaica is to attain its goal of moving up the value chain in ICT, policies should support an integrated and fast-moving sector strategy, including international benchmarking, since ICT is a sector where country level performance information is routinely shared around the world.

**Table II.3. Outsourcing companies in Jamaica**

<b>Company</b>	<b>Type of service</b>	<b>Number of employees</b>
E-services	BPO, Technical support, Customer service	2,700
ACS	BPO, Payroll, Customer service	Approx. 1,400
Vista Print	Graphic design	250
Alliance One	Debt collection	Approx. 500
West Corp	BPO, Customer service	Approx. 600
Tympana	Debt collection, Customer service	Approx. 200
Accent	Tech support, Customer service	Approx. 250
Professional Axxess	Debt collection	Approx. 150
West Indies Call Center	Customer service	60
National Asset Recovery Services	Debt collection	Approx. 900
Flow Jamaica Ltd.	Broadband services, Internet, Telephone and cable services	Approx. 400
<b>Subtotal</b>		<b>7,410</b>
Approx. 12 such other operations with a further 5 projects coming on stream in financial year ending 2008		<b>6,590</b>
<b>Total</b> (approximate figure provided by JTI)		<b>14,000</b>

*Source:* JTI.

*Note:* All above companies have Free Zone Status.

*Market structure*

FDI can have both positive and negative effects on market structure in host countries. On the one hand, the entry of a foreign investor may add supply to local markets, lowering prices and pressuring local firms to improve their production processes and product quality. On the other, due to the scale of some international firms, they can reduce competition in various sectors, or hurt domestic firms with their high demand for local factors of production, a problem especially acute in small economies.

There is some evidence that FDI entry into *Estonia* has reduced competition and has crowded out indigenous firms in the banking sector and, to a lesser extent, in wholesale and retail trade. This effect may be related to the small size of the market (Tiits, 2007). Nevertheless, there is also evidence that high levels of profitability have induced new entrants, a result that has occurred in the banking sector with established banks challenged by a new foreign entrant. Telecommunication privatization in 1992 also resulted in a monopoly position for Estonian Telephone, although this sector was subsequently opened up to competition as a condition of entering the European Union.

In *Jamaica*, the attraction of larger-scale foreign hotels has led to concerns of crowding out in the tourism sector (box II.3). Other structural issues arose when initial privatization of telecommunications resulted in unsatisfactory performance by a monopoly foreign investor. After a renegotiated agreement to permit more competition, another foreign investor, Digicel, entered the market with markedly better results. Similar difficulties exist in electricity infrastructure where a privatized joint venture among foreign affiliates has not yet achieved needed levels of investment and service reliability.

### Box II.3. Size matters in tourism

There are two major size issues in tourism, related to foreign large all-inclusive hotel developments: the socio-economic challenges and the competitive difficulties facing small Jamaican firms.

There has been controversy surrounding FDI in large all-inclusive Spanish hotels located in the north coast of Jamaica in the 2000s. The employment associated with such 400 bedroom hotels is substantial. Wages are relatively low, but there is some skills development through the minimum standard training requirements for employment and subsequent training undertaken by the hotels themselves. However, there are concerns about the ability of a small region within a small country to cope with large-scale projects. A major burden is placed upon the environment and supply of utilities (e.g. electricity and water). In addition, there are challenges in transporting large numbers of hotel employees from outlying areas especially at night-time given crime problems. Also, the lack of accommodation for employees could encourage squatting and associated social problems. Without careful long-term planning, there are clear limits to the ability of a small country to assimilate a concentration of such large projects, whether in tourism or other industries.

Another challenge derives from the ownership of hotels in Jamaica. While there are a number of large, up-scale Jamaican-owned TNC hotel groups, the majority of Jamaican hotels are small. For example, the Hibiscus Lodge/Almond Tree restaurant has 26 rooms and 40-50 staff. It focused historically on North America and meals for tourists. The number of meals served has however dropped from 75,872 in 1987 to 47,000 in 2007, in part because of the all-inclusive hotel competition. Rates in all-inclusive hotels are very competitive making it difficult for small hotels to compete for labour. The rate of decline of meals served slowed in the 2000s as the hotel/restaurant diversified into the domestic wedding and Government conference markets, but Hibiscus Lodge has not been able to access the growing cruise ship market. This traditional local hotel is perhaps typical of many, requiring investment to upgrade facilities (the Hotel Incentives Act applies to all hotels with at least 10 bedrooms), more active marketing, and a new generation of owner/managers. Although the Jamaica Hotel Tourist Association has not provided active support for small hotels, joint marketing programmes might help.

*Source:* Based on interview with Hibiscus Lodge, 19 January 2008.

The challenges of market size are also apparent in the infrastructure sector. Sufficient scale is essential to attract the quality of FDI needed to improve key assets, but maintaining some degree of competition generates more effective outcomes. One potential solution is to retain state ownership in some sectors, but this approach showed mixed results. Estonia failed to complete a privatization of electricity and had to renationalize the railway system, although it continues to struggle. Jamaica's Government operated ports efficiently, but lagged behind in expanding and modernizing water and sewerage.

### *Indirect contributions*

There is little evidence of Estonia adopting policies specifically aimed at maximizing the indirect contributions of FDI. Similarly for Jamaica, in contrast to the active programmes to target and promote foreign investment, policies to generate longer term contributions were quite limited until very recently. Moreover, little research has been done in this area, making it additionally difficult for decision-makers to weigh policy choices and evaluate their potential outcomes.

Though difficult to link to specific government policies, there are still some examples of indirect, longer-term contributions from FDI in Estonia and Jamaica. These have been visible principally through spillovers from foreign affiliates to the local economy (although less so in the case of Jamaica), as well as the upgrading of TNC affiliates. Partly related to these processes, a new phase of outward FDI has been underway in both countries, led by foreign affiliates and indigenous companies seeking to expand into larger markets.

### *Spillovers from FDI*

Foreign affiliates need to establish close links with the domestic economy if local firms are to enjoy the full benefits from

FDI inflows. These benefits can come about through several channels, including, for example, linkages with local supplier firms, pressure on local competitors to upgrade their technology and production processes, and labour mobility between foreign and domestic firms (Blomström *et al.*, 2000).

In *Estonia*, there is evidence suggesting that linkages between foreign affiliates and local suppliers have been weak. Foreign affiliates identify the main impediments as shortages of potential local subcontractors, high costs, insufficient scale of production, poor quality of labour, and inadequate technological capability among Estonian firms (Foreign Investor Survey 2006). In general, these findings point the lack of absorptive capacity among local firms, which partly reflects differences in the relative size of TNCs and indigenous firms in small economies. Few policy measures or TNC initiatives have been put in place to overcome these weaknesses.

Yet, there are still some examples of domestic firms in Estonia having benefited from the presence of foreign affiliates. One study noted that “spillovers are of considerable magnitude in Estonia” (Sinani and Meyer, 2004, p. 461), though this result has been conditional on the type of FDI involved.<sup>9</sup> The same study suggested that spillovers might have taken place through “competition effects”, forcing domestic firms to use existing technology more efficiently or to look for new technology. By upgrading their operations, domestic firms have been able to compete with more efficient foreign firms, while inefficient indigenous firms have been driven out of the market. Spillovers have also likely resulted from a similar, yet conceptually distinct, “demonstration effect,” where domestic firms have observed foreign affiliates operating at higher levels of technology and have adopted that approach. Labour mobility effects – whereby local firms attract and retain workers previously employed by foreign affiliates – have not likely been significant in Estonia, because foreign firms have

typically employed and retained the most qualified local labour by offering higher wages.

In *Jamaica*, there is only limited evidence of indigenous technology development and technology transfers from FDI to local firms (Barclay, 2005). This is primarily due to the lack of interaction between foreign affiliates and local firms and institutions. In many areas of economic activity, such as tourism, apparel and information services, the TNC-owned sector has tended to operate separately from the domestically-owned sector.

There has been particular concern regarding the ability of Jamaica to assimilate and benefit from major projects in the tourism sector. The leakage rate for the industry in Jamaica is estimated at 50 per cent, making the country fourth among the 11 Caribbean countries for which data were available (the highest leakage was in the Bahamas where the figure was 85 per cent). Leakages derive from the very high import content in tourism, limited local supply and weak inter-sector linkages. A major challenge thus relates to the need for improved linkages in a sector where so much of the value chain is currently handled outside Jamaica.

More recently, however, several programmes in Jamaica have aimed at boosting the capacity of local firms to interact more intensively with TNC affiliates. For example, the JTI Corporate Plan 2007–2010 focuses on creating integrated intra- and inter-industry clusters. Sectoral targets include creative industries, ICT, manufacturing, agribusiness, professional services, and tourism. All of these areas are to be developed as clusters to enhance indirect contributions through: increasing the range and value of local components in the cluster's international value chain; encouraging linkages among sectors and clusters; facilitating value added strategies among firms including branding; and enhancing innovation. JTI has collaborated on these initiatives with other Government agencies and international partners.<sup>10</sup>

*TNC affiliate expansion and upgrading*

Though limited, there are notable examples of TNC affiliate expanding and upgrading in Estonia and Jamaica. Over the long run, these can increase positive contributions associated with FDI through the relocation of supplementary and higher value-added activities to local foreign affiliates, including regional headquarter (RHQ) status. Often, upgrading entails more deeply embedding a firm in the local economy, and thus may also increase the likelihood of spillovers.

One significant example of foreign affiliate expansion and upgrading in *Estonia* is Hansabank (box II.4). Now fully-owned by Swedbank of Sweden, Hansabank had responsibility for group banking services in all three Baltic countries and had expanded its operation into Bulgaria, Romania and the Russian Federation. Other foreign banks have followed this model. Upgrading appears to have been more limited in the manufacturing industry. The original strategy used by TNCs of outsourcing to low cost Estonian affiliates has been vulnerable to rising labour costs. There is some evidence of indigenous firms meeting these challenges by upgrading, but less evidence of foreign affiliate upgrading. More commonly, foreign affiliates have responded to rising costs in Estonia by relocating production to another country.

**Box II.4. Hansabank and the Swedbank Group**

Hansabank was established in the early 1990s as a local bank in Estonia. In the late 1990s, as a means of overcoming the constraints of small market size, the bank expanded into Latvia and Lithuania. In the aftermath of 1998 financial crisis, Hansabank merged with the second biggest bank in Estonia (Hoiupank). In turn, a majority of Hansabank shares were acquired by Swedbank of Sweden and the bank's expansion in the region became even stronger.

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**Box II.4 (concluded)**

Hansabank has provided cross-border banking services in all three Baltic States as well as in the Russian Federation. For example, in 2006, FDI into Latvian, Lithuanian and Russian affiliates totalled \$868 million, all of which was consolidated on the company's balance sheet in Estonia. The Baltic economies have been treated as a single market, with Estonia acting as its RHQ, although services have been provided on a country basis. New services and products have been primarily developed and tested in Estonia, and then transferred (with adaptation to local needs and tastes) to Latvia and Lithuania. Similar to smaller Estonian-owned investment banks, Hansabank became increasingly active in Bulgaria, Romania and elsewhere. Reasons for Swedbank using its Estonian affiliate as a platform for outward FDI relate to better knowledge of the local situations and the particularities of developing markets; readiness to take higher risks; faster decision making; and the lower costs of operating from Estonia.

ICT systems development has also been a key competence of Hansabank, as the bank is among the largest software companies in Estonia. The adoption of Hansabank-developed ICT systems, not only in the Latvian and Lithuanian subsidiaries but also by Swedbank, is an example of reverse spillovers from the foreign affiliate to its parent after the acquisition.

In recent years, Hansabank accounted for about one third of Swedbank's profits and 20-25 per cent of its assets. In 2005, Swedbank purchased 100 per cent of Hansabank shares, completing its acquisition, and in 2009 Hansabank changed its name to operate as Swedbank.

*Source:* UNCTAD interviews and survey with Hansabank and other respondents.

In *Jamaica*, examples of TNC affiliate upgrading and expansion exist in the bauxite, manufacturing and telecommunications industries, but the country faces challenges when it comes to establishing itself as a major centre for RHQs. In the bauxite industry, foreign affiliates have increasingly located their processing activities in the country, which has increased the

value of these exports (box II.5). In the manufacturing sector, Jamaican-listed Desnoes & Geddes, brewer of the iconic beer Red Stripe, and 58 per cent owned by United Kingdom-based Diageo, has expanded its operations and enhanced value added in the Jamaican economy. Following a sizeable investment (approximately \$87.3 million) in a new production facility in 2001 (substantially supported by Government incentives), an international marketing specialist was appointed to systematically develop export markets. The company has always been a major exporter to diaspora markets, where the United States accounts for 75 per cent of exports.

#### **Box II.5. FDI in Jamaican bauxite**

FDI in bauxite has a volatile history in Jamaica. In the 1960s, there was substantial investment by United States and Canadian companies, but this dropped thereafter, due to the non-conducive political environment for foreign business from 1972 to 1980. After industrial and labour disputes were resolved, FDI began to pick up again in 1998, although productivity gains were offset by low world market prices in the aftermath of the Asian financial crisis. FDI in Jamaica has been strongly influenced by the industry's investment climate and potential profitability. An important recent development has been the entry of Russian-owned Rusal into the industry. Alcoa has also expanded capacity at the Jamalco refinery. The recent ownership structure is presented in table II.4.

A major positive development has been the growth of refining in Jamaica, keeping much more of this higher value-added step in the country. Currently, 70 per cent of bauxite is processed in Jamaica, whereas in the past approximately the same proportion was shipped as raw bauxite. The Jamaica Bauxite Institute (JBI), first established in 1976, now has a mandate including pollution control and environmental monitoring. Appreciating the socio-economic impact of the industry, the Bauxite Community Development Programme (BCDP) was created in 1996 (and managed by JBI) to reinvest earnings from the industry in communities close to mining operations, including social and physical infrastructure, and to implement income and employment generating projects.

**Table II. 4. Ownership structure in Jamaica's bauxite industry**

<b>Company</b>	<b>Ownership per cent</b>
<b>Bauxite</b>	
St Ann's Bauxite	Century Aluminium and Miranda Inc. 49 per cent; Government. 51 per cent
<b>Alumina</b>	
Windalcan	Rusal (Russian Federation) 93 per cent; Government. 7 per cent
Jamalco	Alcoa 50 per cent; Government. 50 per cent
Alpart	Rusal (Russian Federation) 65 per cent; Hydro Aluminium (Nordic) 35 per cent

*Source:* Jamaica Bauxite Institute, March 2008.

In telecommunications, Digicel, an Irish-owned mobile phone operator (box II.6) illustrates the significant positive economic contributions that a single TNC can make through its expansion. The company was launched in Jamaica as a new TNC venture by a foreign entrepreneur and employs 250 people at the corporate headquarters for its domestic and, increasingly, international operations. Digicel's success has influenced international perceptions of Jamaica, though the company is not a brand-name global TNC.

Recognition as a regional centre or headquarters for the Caribbean area is an important step in the process of affiliate upgrading for Jamaica. However, aside from the example of Digicel and the country's role as a cargo hub for several European TNCs, Jamaica has had difficulties competing with other countries in the region. Trinidad and Tobago commonly acts as RHQ for manufacturing companies, and some United States pharmaceutical TNCs operate out of Puerto Rico. In financial services, Citibank's RHQ, originally in Jamaica, was moved to Miami in the 1970s at the time of the socialist Government. Other companies like Nestlé and Cable & Wireless report directly to their headquarters in Europe,

and sometimes to their United States RHQs. Jamaica's rather limited role as an RHQ can be partly attributed to poor macroeconomic conditions, the decline of manufacturing, as well as the absence of specific policies for these purposes.

#### **Box II.6. Telecom liberalization and TNC upgrading**

This case of Digicel provides two important lessons for small countries: the contribution of FDI in the liberalization process and the key role which a single TNC can play in economic transformation and the benefits associated with RHQ operations based in a small emerging economy.

In 1988, as part of its telecom privatization programme, the Jamaican Government granted Cable and Wireless (C&W) a 25-year monopoly over local and long-distance traffic, with no bidding process. Dissatisfaction with performance led the Government to negotiate a new agreement with C&W allowing for full liberalization; and an auction led to the entry of Irish-owned mobile phone operator Digicel in April 2001. The Irish entrepreneur behind Digicel was looking to invest in liberalized markets where an existing monopoly situation existed (and with high rates and charges to local customers, low penetration, poor customer service and growth potential). Initially targeting Trinidad and Tobago, the company moved into Jamaica because of its earlier liberalization. By 2008, Digicel had 1.9 million Jamaican customers, an 82 per cent market share of the mobile market, and coverage of 72 per cent of the population.

Contributions of Digicel to the Jamaican economy have been: direct employment of 700 people, including 250 Group HQ employees; about 7,000 jobs in distribution; capital expenditure of over \$1 billion, annual maintenance spending of \$30-40 million; 22 per cent duties on imports of phones and towers; marketing expenditures of 10-12 per cent of revenues; staff training; raising of funds on the local market; lower prices; better customer service; and planned new technologies. Positive effects associated with the Irish connection were also indicated e.g. Irish civil servants have been helping to improve the investment climate in Jamaica.

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**Box II.6 (concluded)**

Potential challenges associated with Digicel's operations have included: exchange rate depreciation; Government bureaucracy; skills gap and lack of experience/unwillingness in the regulatory bodies to allow human capital to be imported; crime, especially in respect of vandalism of towers and theft of generators.

Started as a new venture, Digicel Jamaica has benefited from its status as group HQ, established in 2004. From its Jamaican base and using its experienced roll-out team, the company launched into Saint Lucia and Saint Vincent and the Grenadines in 2003, and in the rest of the Caribbean and Central America thereafter, and has begun lobbying for a third license in Honduras. Paralleling these expansions, the company has ventured into the South Pacific including Papua New Guinea and Vanuatu, with Jamaicans as managers.

*Sources:* UNCTAD interviews and survey with Digicel and other respondents; Wint 2003.

*Moving to outward FDI*

Outward FDI of local firms or foreign affiliates to foreign markets presents an opportunity for enterprises in small economies to attain economies of scale and thus can be considered a “second-generation” method of relieving demand-side constraints in small countries. Tax, regulatory and foreign policies that facilitate outward investment, along with successful measures to remove supply constraints and raise firm productivity are important building blocks to this end. In both countries, this trend is closely linked to foreign investors and local affiliates, who can demonstrate international practices, partner with indigenous firms through joint-ventures, or help provide the necessary resources for their foreign expansion.

Between 2004 and 2007 outflows of FDI in *Estonia* rose steadily (from \$268 million in 2004 to over \$1.1 billion in 2006, and around \$1.7 billion in 2007). With the financial crisis, outward FDI

dropped in parallel fashion with inward FDI during 2008, decreasing to near the \$1 billion mark, or roughly one-half the inflow total. As mentioned, there has been a tendency for these investments to be in the same sectors as FDI inflows to Estonia, including banking, real estate and commercial services.

Estonia has not introduced policies specifically aimed at encouraging outward FDI, yet it has retained an open approach to capital outflows, including the absence of foreign exchange controls. The lack of corporate tax for reinvested profits may also have indirectly encouraged firms to seek new investment opportunities abroad. More generally, the streamlined business environment with low transaction costs allows smaller, more entrepreneurial foreign investors and indigenous firms to expand into foreign markets.

Gaining a foothold in larger markets has been the driving force behind the outward expansion of Estonian enterprises. Securing a supply of raw materials has been a less important reason, and lower production costs and investment incentives elsewhere have played virtually no role in strategic overseas expansion (Liuhto and Jumpponen, 2002). This finding is not unsurprising given that the share of manufacturing-related FDI in Estonia's outward FDI flows has been low. Outward FDI is commonly undertaken through mergers and acquisitions (M&As), especially in less developed markets.

The outward expansion of indigenous firms in Estonia is also associated with new FDI in the form of joint ventures or proactive financial investors. Typically, these have been smaller entrepreneurial foreign investors such as CV-online (box II.7). Recently, a number of investment funds – often registered overseas but managed and owned locally – have begun operating in Estonia to assist the domestic and then international expansion of indigenous enterprises.<sup>11</sup> These funds typically consolidate foreign institutional and local investment. Their targets are in Estonia and the other

Baltic States, Poland, Ukraine and other countries in the Commonwealth of Independent States (CIS).

There is evidence suggesting that rising outward investment may contribute to improvements in labour productivity in the Estonian economy. A study drawing on 2002 data for Estonia (Vahter and Masso, 2005) suggests that foreign-owned and indigenous Estonian firms that have themselves invested abroad tend to have higher levels of productivity. This has the case in both the manufacturing and services sector.

**Box II.7. Example of an Estonia-founded firm that internationalized**

CV-Online, a recruitment agency, was founded in 1996 by four Estonian entrepreneurs. Constrained by a small local market, the company began to internationalize early by expanding to Latvia and Lithuania. In January 2000, the company obtained investment from venture capitalists LHV Ventures (Estonia) and Esther Dyson (United States). LHV was selected for its entrepreneurial experience and Esther Dyson for its contacts in Europe and knowledge of the on-line recruiting sector. Both companies acquired a 35 per cent stake in CV-Online, for \$1million each. With these investments, CV-Online was able to enter major Central and Eastern Europe (CEE) markets.

In 2001, the company expanded further through the participation of 3TS Venture Partners, one of the leading Central European investment funds. By October 2002, CV-Online had over 330,000 registered jobseekers in the CEE region and offices in Estonia and six foreign countries: the Czech Republic, Hungary, Latvia, Lithuania, Poland and Slovakia. In that year, it ranked 14<sup>th</sup> in Deloitte & Touche's "Central European Technology Fast 50", with 731 per cent revenue growth between 1999 and 2001. New capital and expertise enabled CV-Online to internationalize quickly although it remains Estonian-managed. The company is developing proprietary services and technological solutions. There has also been important financial support from the Estonian Technology Agency in the form of a \$268,000 loan to help the company develop its online recruiting system.

FDI outflows from *Jamaica* have been more modest (\$102 million in 2008). As in the case of Estonia, Government policies have permitted outward FDI without explicitly promoting internationalization as a path to growth. The majority of outward FDI comes from Jamaican-owned firms have ventured abroad in tourism and entertainment (e.g. Sandals and SuperClub Hotels), agro-processed food and beverages (e.g. Grace, Kennedy and Co. and Jamaica Broilers), printing and publishing (e.g. The Gleaner Company), finance and insurance (e.g. Jamaica National Building Society), and retail and distribution (e.g. Island Grill). For these firms, innovation, strong leadership, commitment to high standards and international benchmarking, and strategic alliances have been important to their success (Wint, 2003 and UNCTAD interviews).

Motives for internationalization have varied. A number of firms have expanded overseas to serve the diaspora market after building competitiveness domestically with well known brands. Others have outgrown the Jamaican and Caribbean markets or developed internationally as trade liberalized or earlier trade preferences were eroded. Acquisitions have also been a route into international markets. For example, Grace, Kennedy and Co. established important links with Canadian interests in support of its brand and more recently acquired food distribution operations in the United Kingdom.

### ***Conclusions on FDI contributions***

The growth witnessed in *Estonia* and elsewhere in CEE has been built predominantly on direct contributions of FDI. Indirect effects, such as FDI linkages and spillovers, and the accumulation of technology and skills in indigenous industry have been relatively limited,<sup>12</sup> although the upgrading and internationalization of local firms and foreign affiliates in recent years has shown promise. In part, these mixed results are a consequence of initial weaknesses in the capacity of indigenous firms in Estonia to absorb knowledge and technology introduced by TNC investors. The rise of an investment

banking industry that provides credit to Estonian firms, however, may be improving this capacity.

Similarly, the benefits of FDI in *Jamaica* appear to have come primarily from direct contributions, which are typically more evident. Foreign affiliates have a strong presence, as measured by their role in capital formation, job creation and services exports. There are some examples of foreign affiliates providing indirect contributions, but to date such cases are not abundant. Although there are signs of internationalization by local foreign affiliates and indigenous firms, the growth of outward FDI has been more limited compared to Estonia.

### Notes

- <sup>1</sup> Third quarter of 2007, based on data from the Bank of Estonia. These top five companies include three subsidiaries of Scandinavian universal banks that operate across the Baltic region, one publicly listed telecommunications company with controlling Scandinavian ownership, and a transport and transshipment (oil and petrochemicals) company.
- <sup>2</sup> Macroeconomic instability in the late 1990s undermined some of the NIP's objectives (Wint, 2003). In addition, the programme has been criticized for not adequately involving the private sector (JCCP 2006) and for its slightly protectionist leanings with respect to import substitution and protection of infant industries.
- <sup>3</sup> The National Planning Summit 2007 proposed a new set of tax incentives for both local and foreign investors, as well as incentives for targeted sectors.
- <sup>4</sup> The World Bank (2005a) calculates that reducing debt to 100 per cent of GDP within seven to eight years would mean running a primary surplus of 12 per cent of GDP in the absence of major shocks.
- <sup>5</sup> Total population of member States is just over 15 million, the largest country being Haiti with a population of 8.7 million (and also the poorest in terms of GDP per capita). Jamaica (2.8 million) is the second largest country in CARICOM and ranks 10<sup>th</sup> in terms of GDP per capita.
- <sup>6</sup> See Government report on "A Transformed Education System", cited in Witter (2006).
- <sup>7</sup> Tympana, a call centre company, noted that telephone costs had decreased from \$7,000 per month with Cable & Wireless to \$1,000 per month with the broadband company Flow.
- <sup>8</sup> The Government also launched the *Apparel Industry Special Assistance Programme* as a response to the closures. The government also established a Productivity Centre for small and medium-sized enterprises (SMEs) and a Fashion Industry Secretariat providing technical services in production, technology, design and marketing.
- <sup>9</sup> Sinani and Meyer (2004) find that labour-intensive FDI generates larger spillover effects than capital-intensive FDI. Vahter and Masso (2005) find low spillovers to local firms in manufacturing but higher levels in

services. Other studies find higher spillovers in industries oriented towards the domestic market.

- <sup>10</sup> Two collaborative initiatives are the Jamaica Cluster Competitiveness Project (JCCP) (assisted by DIFID and USAID funding) and the Private Sector Development Project (PSDP) (supported by EU funding).
- <sup>11</sup> Estonian tax policy is still not considered stable enough to register investment funds in Estonia.
- <sup>12</sup> This applies much more broadly for the CEE countries (e.g. Piech and Radošević, 2006).



### **III. POLICY PRACTICES AND LESSONS FOR SMALL COUNTRIES**

Small countries face unique challenges in designing policies to attract and benefit from FDI. An examination of recent experiences in Estonia and Jamaica reveals some similarities but also significant differences in approaches and results. The outcome of this study provides useful lessons for policymakers in small developing countries. Whether the overarching economic approach is more liberal, as is the case in Estonia, or involves a higher degree of Government intervention, as in Jamaica, policymakers should recognize the demand and supply side constraints in small economies. They should also formulate, taking into account the size factor, FDI policies that maximize direct economic benefits and generate indirect contributions that are important for long-term development.

The generalized lessons from the two country cases are that:

- Policies to remove cross-border barriers to capital and increase access to foreign markets are imperative to reducing demand-side constraints in small economies.
- Initial success in attracting FDI can quickly generate supply-side constraints in small economies (particularly with respect to skills and infrastructure). This will limit economic benefits and discourage further FDI unless government action addresses early bottlenecks.
- Successful FDI attraction to small countries provides the most visible direct benefits in terms of capital formation, exports and employment. On the other hand, the impact on R&D and market structure is less certain and more dependent on specific country conditions and policies.
- Small countries generally have small domestic-market companies that do not automatically benefit from

interaction with foreign affiliates. In this regard, policies on FDI that foster indirect effects through linkages, upgrading and spillovers could assist indigenous company development and ultimately enable a new generation of outward FDI.

### **1. Adopting policies to facilitate access to larger markets**

Generally, a significant proportion of FDI inflows are in businesses that can serve the domestic market. This is also the case for small countries. However, if small countries wish to outperform in the attraction and contribution of FDI, it is important to recognize small domestic market size as a constraint and pursue policies to offset this disadvantage. Jamaica formally acknowledged this goal in its NIP development plan, stating that “given the small size of the domestic market, there is no alternative avenue for sustained growth other than through exports”. Estonia’s rapid negotiation of FTAs with neighbouring countries and later its membership of the European Union and the WTO showed a similar recognition that liberalization policies could expand its market size.

*Prioritize trade agreements that add market scale for export-oriented FDI*

The two countries are located close to neighbouring markets with which they had close ties that were formalized through FTAs and membership of regional integration agreements. Estonia energetically pursued trade relationships with relatively larger Nordic countries, signing free trade agreements with the neighbouring economies of Sweden and Norway within two years of independence. The Nordic countries and Baltic neighbours have accounted for more than half of Estonia’s exports, effectively expanding the market available to domestic enterprises or foreign affiliates. Estonia also placed a high priority on attaining early entry to the European Union, initially achieving a free-trade pact that was

operative within four years of independence, before attaining EU membership in 2004. From 1995 to 2008, the EU market (aside from the Baltic and Nordic countries) absorbed 20 per cent of Estonia's exports, a share which has been growing in recent years.

By contrast, Jamaica spent much time as a founding member of CARICOM, a small and fragmented block whose common external tariff and coordination policies have been incompletely or inadequately implemented. Jamaica was already a major economy relative to the CARICOM region and thus did not significantly alter its small market constraint. In practice, the volume and sophistication of intra-regional trade in CARICOM was low, representing less than five per cent of Jamaica's exports from 1991 to 2008.

Successful domestic companies understood the constraints of a "small region" with limited disposable income and looked beyond the Caribbean to pursue their interests. Government policies provided limited assistance in opening up these larger opportunities. However, Jamaica's inclusion in the Caribbean Basin Special Access Programme for Apparel provided preferential access to the United States market that spurred apparel exports, although these exports were later displaced by NAFTA. Bilateral agreements with the United States and the European Union, complemented by an EU-CARICOM economic partnership agreement, provided some trade benefits that enhanced business assessments of Jamaica's market potential. From 1991 to 2008, nearly two thirds of Jamaica's exports were split between the United States and the EU.

*Focus on trade agreements with likely capital exporting countries*

A key feature of Estonia's FTAs is that initial partner countries were also the most likely source of inward FDI. The Nordic countries accounted for over three fourths of Estonia's FDI inflows, dwarfing the 1 per cent represented by the other Baltic

States and the 11 per cent by other EU countries. A part of Estonia's manufacturing trade took the form of intra-firm supplies. Thus, Nordic TNCs outsourced some of their components production to new affiliates in Estonia, taking advantage of zero tariffs, lower labour costs and Estonia's proximity for just-in-time supply. The integration of FDI and trade was also evident in the banking sector where substantial inward FDI, in particular from Sweden, was linked to trade in services that reached outward to broader regional markets. Estonia's number three ranking on "Trading Across Borders" in the 2010 World Bank's *Doing Business* report reflected both the unilateral lowering of trade barriers and the simplified customs and other procedures in trade agreements that facilitated inter-affiliate business coordination in TNC networks.

In contrast, Jamaica could expect to receive relatively little FDI from its CARICOM neighbours; they were not the home countries of significant TNCs. The historically dominant United States proportion (nearly four fifths) of Jamaica's FDI inflows appeared largely unrelated to trade in the manufacturing sector, at least after NAFTA superseded the Caribbean apparel trade accord that had attracted some United States FDI into Jamaica. Except for the alumina exports, most other trade-related FDI arose from trade in services, primarily tourism and ICT (including call centres), which does not seem related to particular trade agreements other than those under the WTO.

*Avoid over-dependence on regional economic ties*

Estonia drew three fourths of FDI inflows from the Nordic countries and sent half of its exports to the Baltic Sea region. These ties constituted the quickest, most natural way to forge new relationships as the country reoriented itself from the trading patterns established under the Soviet era. However, Estonia's liberalization policy clearly set entry into the European Union as a priority, seeking broader regional ties and enhanced stability that

would accompany an EU membership and accession to the Euro zone. As a result, the EU countries outside the Baltic Sea region have increasingly become sources of inward FDI and export destinations.

Jamaica also displayed a highly dependent pattern for FDI inflows, historically drawing four fifths from United States sources. However, only one third of its exports and its imports were directed towards the United States and EU market respectively. Some Jamaican programmes now seek to diversify the country's FDI dependence, for example, by promoting tourism opportunities to hotel TNCs in Spain whose new FDI projects can help offset the United States dominance. Russian FDI had also helped diversify source countries and increase competition in the alumina sector.

## **2. Promoting location-specific advantages to attract FDI**

*Evaluate options ranging from broad-based efforts to sub-sector promotion*

A wide range of options is available to countries to deal with their small size constraints. For instance, unique location-specific advantages can be promoted through fiscal and financial incentives or by showcasing other advantages, including natural resource endowments.

Estonia chose not to pursue policies that actively targeted inward FDI in specific sectors. Estonia depended instead on its broadly "open door" policy and non-discriminatory national treatment guarantees to establish an investment climate that would draw needed FDI to help spur its transitional economic growth and development. The rapid transition from socialism to a market-based economy provided the opportunity for such a wide-ranging programme of liberalization. The Estonian Investment and Trade Agency focused essentially on information dissemination and

project facilitation activities. This approach matched the country's policy on attracting FDI; facilitating market-directed flows by removing obstacles (including a lack of information) without relying heavily on the use of incentives. However, evidence suggests that the zero per cent corporate tax rate for re-invested earnings increased the attractiveness of Estonia to foreign investors as a location for production and as a base for further regional expansion.

Jamaica followed a more activist FDI targeting policy during the period under study. The economy had been largely based on three economic pillars – mining (bauxite/alumina), tourism and remittances. The NIP sought to expand growth opportunities in mining and tourism while promoting diversification to other activities, including apparel and light manufacturing, ICT, entertainment and sports. Unfortunately, unfavourable macroeconomic conditions limited the NIP's success. Effectively, while tourism and mining continued to attract new FDI, the growth of FDI inflows into the ICT sector was offset by the demise of the apparel's initial promise.

Jamaica's IPA was more pro-active than the one in Estonia. It promoted FDI in most sectors targeted by the NIP, while other ministries only handled a few types of investments, such as in mining. Free zones, tax incentives and concessionary financing were used to attract FDI in targeted sectors and/or for export promotion. These incentives also served to offset some of the less attractive features of Jamaica's investment climate.

*Adopt proactive measures to tap the FDI attraction potential of privatization programmes*

When a country's existing State enterprises become part of a privatization programme, simply allowing foreign investors to acquire them is an indirect or passive form of targeting. Using more proactive measures, such as preferential arrangements for investors, can on the other hand lead to better outcomes, especially in sectors

where the attraction of FDI could be more challenging. This is indeed the case for infrastructure, such as electricity, roads or telecommunications, where expansion and upgrading can provide a solid basis for FDI attraction in other sectors. In these cases, decisions on the sequencing of infrastructure privatizations, the provision of fiscal or financial incentives and choices to retain some areas under state ownership with a view to investing in these areas prior to their privatization will significantly help in shaping the country's investment climate.

For example, Estonia's privatization programme effectively channelled some FDI to infrastructure, including in the telecommunications sector which needed significant upgrading. The concession agreement gave the new company, created by Finnish and Swedish investment, a monopoly over services until 2000. This was seen, at the time, as a necessary condition to attract quality investors to a small domestic market. In the case of Jamaica, attractive privatization opportunities were also seen as a way to upgrade existing infrastructure. In 1988, Cable & Wireless was granted a 25 year monopoly in the telecommunications industry. The recent privatization of Sangster International Airport similarly granted a 30 year concession for the operator. Although preservation of preferential market positions may help attract market-seeking FDI, careful attention and regulation is necessary to ensure positive outcomes for consumers.

### **3. Minimizing supply-side constraints for effective TNC operations**

#### *Overcoming supply constraints is difficult*

The experiences of small countries show that successfully attracting FDI to produce for large external markets can quickly lead to local supply constraints. Significant FDI inflows and/or very large investment projects can strain supply-side resources. In small economies, bottlenecks in labour, skills and infrastructure can

appear rapidly. Labour cost advantages may soon erode when conditions tighten in a small labour market. Sections of the workforce may be high-skilled but there may not be a critical mass of relevant skills for business expansion. Increased demands on ports, airports, water and power systems can also arise more quickly than anticipated. Estonia and Jamaica both experienced difficulties in maintaining adequate supply of labour and skills. While the two countries managed to expand infrastructure capacity significantly, they also experienced problems associated with introducing private sector investment.

*Retaining FDI by expanding the labour supply and/or upgrading production processes*

The initial phase of FDI in Estonian manufacturing attracted Nordic TNCs seeking nearby lower labour cost. Estonia's small labour pool was quickly absorbed, leading to real wage increases of 10 to 15 per cent annually. Despite losing population at the time to migration, Estonia did not ease its immigration policies to import workers to relieve the labour shortage. As a result, FDI based on low cost labour increasingly looked for opportunities in other countries, closing facilities no longer cost competitive in Estonia. By using immigration to import workers, a small country might gain time to promote policies that encourage foreign affiliate upgrading to less labour-intensive processes that also increase domestic value-added production. However, this strategy must be complemented by skills policies (e.g. education and vocational training) that meet the needs of these more sophisticated processes.

Jamaica's labour supply problems have been more localized. For example, some large tourism projects exhausted available pools of labour in nearby settlements. Policies and advance planning to integrate labour policy with transportation infrastructure can, in such cases, encourage labour mobility. While significant emigration from Jamaica continued, it is questionable whether this

posed a serious labour pool constraint on growth, as the country continued to experience relatively high rates of unemployment and underemployment. In fact, the negative effect of migration on the investment climate is more related to a “brain-drain” effect than general labour supply issues.

*Building skills development capabilities adapted to evolving FDI needs and to increased value-added activities*

Small internal labour markets limit the level of human capital specialization. Surveys of foreign investors rank Estonia’s major problem as a lack of qualified labour, with insufficient vocational training and continuing education capacity to meet FDI requirements. Similar to policy options for dealing with a general labour shortage, easing immigration procedures for skilled labour could loosen this constraint. Nevertheless, by relying on market forces to determine economic growth sectors, Estonia has limited capacity to determine the industrial structure through skills policies. Instead, it must rely on national education and training resources capable of responding to private sector developments. Cooperative programmes with universities and training institutes would help reassure investors regarding such a national capability and commitment.

Jamaica pursued a more proactive policy toward skills development, if aimed initially at a somewhat lower attainment level. However, questions arose about the educational quality of public schools and many qualified graduates of tertiary schools migrated. Jamaica levied a 3 per cent payroll tax (three times the Caribbean average) to fund customized training programmes to meet sector and company requirements. For example, when the demise of Jamaica’s apparel sector cost thousands of jobs, mainly women, the Government promoted FDI in the ICT sector to offset this loss. Some 14,000 new jobs were filled mainly by high-school educated women. Although the sector currently requires only training

appropriate to call centres, the Government is already promoting upgrading into software development. A Software Developers Association was set up to identify training needs and possible initiatives to encourage the return of trained diaspora software engineers to develop this sector.

*Using the diaspora as a potential pool of labour and skills*

Although Estonia's migration dissipated after 2000, members of the earlier diaspora possess knowledge and skills valuable to the national economy. Stemming the migration outflow has been important, but fostering returns among the diaspora would add new capabilities to the country's available human skill base. Using former emigrants to help fill labour and skill gaps may also be politically more feasible than relying on new immigrant groups.

Improving conditions concerning violence and crime in Jamaica may encourage the return of skilled citizens who are part of the country's large diaspora. Although remittances constitute a significant capital inflow for the country, the missing human capital seriously limits Jamaica's capacity to fully tap the benefits of the country's investments in public education. Many returning individuals would possess an entrepreneurial spirit as well as knowledge and training in overseas businesses. They could introduce new ideas and transfer more efficient processes to Jamaica, sparking opportunities for local business development and growth.

*Anticipating infrastructure bottlenecks from large exporting or tourism projects*

Investor surveys in Estonia make little mention of infrastructure, in part because quality infrastructure services are expected in developed economies. Also, the sharp reduction in output following independence created a cushion of excess infrastructure capacity, particularly in the electricity sector.

Nevertheless, infrastructure shortages emerged faster than expected e.g. in the Tallinn airport. Other pressures on office facilities and housing may recur as the economy recovers from the current global economic slowdown.

Infrastructure deficiencies are a key aspect of Jamaica's supply barriers. The tourism sector highlights the difficulties for a small country when large FDI projects are not accompanied by adequate infrastructure improvements, especially in airports, roads, water and sewerage. Jamaica's severe fiscal budget problems constrained a public sector response to infrastructure bottlenecks. On the other hand, some aspects of infrastructure policy, such as the Port Authority of Jamaica and the privatization of Sangster airport, have been important for supporting FDI-related activities in tourism.

*Introducing private participation to address more quickly infrastructure constraints*

In Estonia, privatization programmes had mixed impact. The early entry of Finnish and Swedish telecommunications investors was associated with rapid increases in mobile phone and Internet services. There were, nevertheless, signs of problems. For example, the granting of an exclusive concession to Estonian Telephone Ltd. in 1992 led to fears of market abuse. The privatization of Estonia's railway system to a foreign and domestic consortium failed to increase investment and achieve efficiency gains, leading to the renationalization of the railway after five years. An expected sale of the electricity system to Enron collapsed with the United States company's bankruptcy.

These outcomes highlight the need for adequate regulation and for careful planning and sequencing. For example, the potential for monopoly abuse by Estonian Telephone was effectively addressed when entry to the European Union required ending the company's exclusive market control. The phasing out of the

company's special position was interpreted as a way to balance the need for initially attracting infrastructure FDI to a small market while encouraging competition in the sector could eventually emerge in the longer run.

Jamaica had a similarly mixed experience with private participation in infrastructure. A key infrastructure privatization occurred in 1988, when Cable & Wireless gained a 25-year monopoly in telecommunications with no bidding process. Subsequent dissatisfaction with performance led to a new agreement in 2001 that opened the sector to competition, leading to new FDI by Digicel. This led to lower prices, improved service delivery and fostered FDI in the targeted ICT service sector. By contrast, FDI in the electricity sector has been less successful with cost and reliability still being a concern for businesses ranging from mining to tourism. Controversy over tolls charged by a French highway operator showed the difficulties of legitimizing and explaining the rationale of private participation to the population. This record of FDI in infrastructure made it difficult to further promote privatizations in spite of the fact that the Government lacks funds to upgrade infrastructure. For instance, business expansion would require road maintenance while large-scale hotel projects would greatly benefit from water and sewerage improvements.

#### **4. Fostering FDI direct contributions while monitoring potential negative effects**

*Adopting a systematic approach to measure FDI contributions and design policies to maximize them*

FDI in Estonia and Jamaica made up a larger share of capital formation than in other small economies. Foreign affiliates in Estonian manufacturing employed half of the sector's workforce, had a higher export propensity and accounted for 90 per cent of private sector R&D. In Jamaica, foreign affiliates have contributed

to job creation, particularly through labour-intensive investments in tourism and ICT calls centres. These have been instrumental in driving exports of services which now surpass exports of goods. Both countries have benefited from FDI-driven export growth and diversification. To further these types of contributions, proactive inducements, as those that Jamaica has introduced in the ICT sector to encourage a shift from call centres to software development, would be necessary.

Policies to maximize direct contributions presuppose the collection of data on the significance and benefits of FDI in a host country's economy. For example, UNCTAD measures the significance of FDI to a host economy through a transnationality index.<sup>1</sup> Estonia ranked third in 2005 among 33 developed economies for which UNCTAD computed this index. Jamaica ranked fifth among developing countries, an important improvement compared to its 16<sup>th</sup> position in 1998.

*Remaining vigilant with FDI potential negative consequences*

In terms of market structure, issues can arise concerning the concentration of market power or the "crowding out" of local enterprises. These potential problems relate to the country's small market relative to the size of many large TNC projects. In this context, the competition framework becomes a priority. In this regard, it may be useful to attract FDI from multiple small or middle-sized TNCs to gradually assess the capacity of communities to absorb larger projects.

In Estonia, competition issues emerged due to large market-seeking foreign investments in the telecommunications and banking sectors. These issues were dealt with by further opening up sectors to further foreign investment, which was attracted by above-market rates of return. In these cases, competition was stimulated by

reducing Government barriers to entry and increasing cross-border integration.

Jamaica's experience with telecommunications in many ways mirrors that of Estonia. While a foreign investor was granted an exclusive market, the unsatisfactory outcomes led to the introduction of additional foreign players in the sector. As a result, the market share of the initial foreign investor declined leading to increased coverage and quality and to lower prices for consumers.

In the tourism sector, the country's success in attracting FDI for large, all-inclusive hotels has sometimes been associated with negative effects on the surrounding communities. The labour and infrastructure needs of these foreign-owned hotels can lead to social and environmental issues as well as raise costs for local firms. For instance, the inclusion of a variety of tourism services in foreign-owned resorts reduced the sales of local hotels and restaurants. Moreover, since these resorts often rely on imports over local supplies, the reduction in demand for local tourism services is not compensated by increased sales by local suppliers.

*Monitoring and compensating for increased economic exposure to global shocks*

Liberalization policies and the promotion of location-specific and sectoral advantages can compensate for the small market size in some countries. At the same time, they also increase the vulnerability of these economies to external shocks. Careful monitoring of such risks and compensatory policies and regulations are necessary for effective macroeconomic management. The 2008–2009 global financial crisis and subsequent recession showed that this is important for both Estonia and Jamaica.

Estonia received the majority of its FDI in the financial sector. The rapid expansion of this sector in Estonia and its exposure

to external shocks made the country especially vulnerable to instability in global financial markets. Consequently, as in the other Baltic States, it was severely hit by the financial crisis in the late 2008. The concentration of foreign ownership in the banking sector (nearly 100 per cent of banking assets were foreign-owned) combined with inadequate financial supervision in the host and home countries, resulted in excessive accumulation of foreign debt. This led to a collapse of domestic demand when global financial pressures arose. However, the country maintained a strong fiscal position and remained on track to join the euro zone. This contrasts with neighbouring Latvia, which was forced to seek IMF support in December 2008.

FDI inflows to Jamaica went primarily into bauxite and tourism. As a result, these sectors became major sources of exports, foreign exchange and Government revenues. However, the world prices of bauxite and tourism sales are very sensitive to global economic conditions. Therefore, when the world economy slowed down in 2008–2009, the Jamaican economy was hit hard and the Government requested the financial assistance of the IMF. Given high existing levels of public debt, adequate fiscal management is essential to complement policies that rely on external markets and a limited range of economic activities. Furthermore, efforts to diversify the economy, as attempted by targeting FDI into the ICT sector, can also help in limiting the impact of external shocks.

## **5. Promoting long-term indirect FDI benefits**

### *Identifying spillover mechanisms*

Spillovers from FDI operations (i.e. intangible benefits brought by the exposure of the local economy to sophisticated foreign production processes) can help improve the national productive capacity of indigenous firms. These spillovers can come

from a variety of mechanisms, including supplier linkages, competition and demonstration effects, as well as labour mobility.

In Estonia, there is some evidence of spillovers that increased productivity of local manufacturing firms. These effects were difficult to link to specific policies and seemed to largely depend on competition and demonstration effects from FDI operations. Local firms lacked sufficient scale, skill specialization and technological capacity to create significant sourcing linkages with TNC affiliates and capture significant benefits from spillovers through expanded cooperation.

In Jamaica, foreign-owned industry had little interaction with local firms to help develop indigenous capabilities. In some cases, the sector or segment of the business chain was simply not conducive to local linkages, such as in apparel, where FDI manufacturers typically moved locations to essentially seek lower-cost production factors. In other instances, the nature of FDI projects limited local linkages. For instance, attracting large FDI hotel projects brought direct capital and employment to Jamaica. However, the “all-inclusive” hotel format internalized much tourist activity, thereby diminishing the spillovers previously enjoyed by local restaurants and smaller providers of leisure activities. As Jamaica seeks to attract FDI, paying more attention to potential FDI indirect contributions could be beneficial. For example, larger FDI projects should not necessarily be strongly promoted if “all-inclusive” hotels isolate tourists from the local economy.

#### *Building absorptive capacity of local firms*

The starting point for encouraging spillovers in a host country is to enhance the absorptive capacity of the local economy. It is especially important to enhance the absorptive capacity among indigenous firms if foreign investors are to increase linkages with local suppliers and if local companies are to benefit from technology

transfers. Government financial support may be needed for local SMEs seeking to improve their capabilities (quality or quantity) to become suppliers to foreign affiliates. Collaborative arrangements with local universities and research organizations can also provide valuable assistance and upgrade SME skills. Even if there is equal treatment between foreign and indigenous enterprises, there should still be initiatives seen to support domestic firms to ensure buy-in and social cohesion. Other aspects of policy include skills development in domestic business and professional sectors as well as in science and engineering.

The absence of more pro-active programmes in Estonia reflected the Government's liberal approach. Yet, Estonia's IPA recently proposed some assistance to foreign affiliates to develop linkages with local suppliers. In Jamaica, linkages between FDI and indigenous businesses were promoted through a cluster approach. Jamaica's NIP put emphasis on the development of linkages in five sectors. The idea was to strengthen the base of existing activities, such as in tourism, entertainment and sports, or develop new business areas such as telecommunications and ICT. The idea behind the clusters was to focus promotional efforts and incentives on attracting FDI to sectors where proximate enterprises can exploit potential synergies and develop sufficient scale to compete in export markets. The risk, of course, was to pick the wrong targets rather than relying on market forces. Moreover, the weak linkages in these industries demonstrate the challenges associated with improving the capabilities of domestic firms to the level necessary to connect with foreign affiliates.

#### *Encouraging the upgrading of foreign affiliates*

The role of successful foreign affiliates is likely to change as their parent TNC's products and processes evolve. FDI longevity is associated with adjustments that lead affiliates to outsource some of their standard operations to concentrate on new or more

sophisticated processes. In this context, opportunities arise for local companies to become suppliers of foreign affiliates generating deeper links with the local economy and leading to potential knowledge and technological transfers. Host countries can thus enjoy a double benefit. The TNC affiliate's local operations make higher value-added contributions to the national economy while local firms capture the outsourced production, expanding and upgrading their own business capabilities.

The two country experiences contain some evidence of foreign affiliate upgrading; particularly with respect to regional headquarter activities, although the overall level of upgrading has remained fairly limited. The Estonian banking sector had some success, most notably with the experience of Hansabank which, after its purchase by Swedbank, expanded operations into neighbouring countries. Yet, Estonia might have been more proactive in advertising itself as a "hub" for the Baltic Sea region or even the CEE and the Russian Federation by emphasizing its physical and communications infrastructure. In light of some constraints that have developed as a result of successful FDI attraction (for example with the Tallinn airport and available office facilities), a promotional programme could have been useful in identifying potential infrastructure "bottlenecks" earlier and facilitated steps to address them.

Jamaica has not specifically targeted FDI for developing "hub" operations, yet a few examples nevertheless exist. For instance, Digicel established its group headquarters in Jamaica in 2004, just three years after entering the country's telecommunications sector. The group headquarters employed 250 people and served as the basis for Digicel's expansion into other countries in the Caribbean and Central America. A few TNCs also used Jamaica's efficiently-run port facilities as a "hub" for their cargo operations while maintaining offices in other Caribbean countries. However, Jamaica confronted difficulties in attracting

other FDI for the purpose of establishing regional TNC “hubs”, the most prominent challenge probably being the high violence and crime rates. Aside from regional headquarters, the bauxite industry upgraded in recent years, as foreign firms began to locally process a larger share of total exports in this sector. Efforts are also being made to push ICT activities towards software development.

*Using inward FDI to stimulate outward FDI*

Outward FDI is generally associated with higher domestic labour productivity and is likely to generate indirect contributions provided that emerging TNCs retain higher value parts of their production chain within Estonia and Jamaica. In the two countries, a new phase of outward FDI recently unfolded; at times led by local companies seeking larger markets.

The two countries had permissive rather than intentional supportive policies towards outward FDI. The absence of foreign exchange controls facilitated outward FDI and, in the case of Estonia, the domestic corporate tax system allowed foreign affiliates to reinvest their profits abroad without being taxed. Moreover, both Estonia and Jamaica have double taxation treaties that were originally signed to support inward FDI. However, they now facilitate outward FDI to treaty partners.

In Estonia, the entry of Nordic banks, and Swedbank in particular, was associated with increased outflows of banking FDI, as these banks used the country as an investment base to access the region. Another development included pro-active investment funds playing the role of identifying and facilitating significant inward and outward FDI. A new breed of local private equity houses acquired and consolidated small companies in the Baltic and CEE countries in order to develop these operations. The transaction costs of entry for new investors are generally low, which enables private investment houses to work efficiently.

In Jamaica, much of the outward FDI was in the agribusiness from companies which survived the decline of the manufacturing sector since the 1970s. So far, the involvement of foreign affiliates in this process did not seem significant. Lacking the stimulus of competition in the domestic market, international benchmarking was an important driver of competitiveness. Other factors included the exploitation of historical niches and brand reputations as well as a focus on serving diaspora markets. Some of these efforts have been assisted by small foreign investors.

*Successful indigenous outward investors are attractive targets for additional FDI inflows*

Successful local outward investors from small countries may become sufficiently large and attractive to be the targets for acquisition by new inward FDI. This could indeed be a natural exit strategy for the founding investors. For example, the expansion of Hansabank into the Baltic region started before its acquisition by Swedbank and continued thereafter. While both Estonia and Jamaica did not show signs of resisting this type of development through some form of a protective “national champions” policy, this issue was not addressed. A possible response would be to develop policies to retain the higher value parts of the group activities in the country and ensure the supply of high value goods and services to the group operations by domestic suppliers.

**Note**

- <sup>1</sup> The index is calculated as an average of four elements: (a) FDI inflows as a percentage of gross fixed capital formation; (b) FDI inward stocks as a percentage of GDP; (c) value added of foreign affiliates as a percentage of GDP; and (d) employment of foreign affiliates as a percentage of total employment.



## **IV. CONCLUSION**

Small countries face special challenges in attracting and retaining FDI, and in designing policies that will maximize its associated benefits for national economic growth and development. While Estonia and Jamaica outperformed their small country peers in attracting FDI over the past two decades, they pursued different approaches which reflected their country conditions and development priorities. The two countries made use of liberalization policies to expand their small market size but Estonia's liberal policy contrasted with Jamaica's planned FD targeting approach.

Neither Estonia nor Jamaica fully anticipated the supply-side impact deriving from their successful FDI attraction. Other small countries can draw important lessons from this when implementing policies to attract FDI. For instance, one of the key messages in this study is the importance of assessing early the bottlenecks in terms of infrastructure and skilled labour that are likely to arise quickly with important FDI inflows. By evaluating policy options and designing appropriate policies to early address these bottlenecks, a country could significantly increase the positive contributions FDI can make to its economy and avoid undesirable negative consequences. Action is also needed when privatization programmes to improve infrastructure can result in a concentration of market power that requires effective public oversight. Furthermore, governments need to consider ways to support local enterprises in developing the capacity needed to establish linkages with TNC affiliates in order to move beyond immediate direct effects and fully tap the indirect benefits of FDI.



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