Economic reforms and foreign direct investment in Iran

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Abstract

This article studies foreign direct investment (FDI) from domestic and foreign viewpoints. From a domestic viewpoint, legal, cultural, economic, social, political, and historical constraints to foreign direct investment will be analyzed and necessary solutions will be proposed. In addition, the author looks at changing global and state policies with regard to foreign direct investment in the past two decades. International bodies such as MIGA and CISID which are affiliated to the World Bank, which try to pave the way for the attraction of foreign investment into less developed countries will be introduced and discussed. Then the necessity of Iran's accession to the mentioned bodies will be discussed as an effort for the attraction of foreign direct investment. At the end, it is concluded that due to importance of such investment in foreign trade of every country, any delay in creating the needed grounds for the attraction of foreign direct investment can marginalize Iran in the global village.

Keywords: Less developed Countries, Foreign Direct Investment (FDI), Attracting FDI, Barriers to Foreign Investment, International Agreements, World Bank.

Introduction

Remarkable growth of foreign direct investment has been one of the main features of global economy during the past two decades. Foreign direct investment means investment by transnational or multinational corporations in a country to control assets and manage production activities in those countries. Growth of foreign direct investment has accelerated since early 1980s and it currently includes 54,000 transnational companies. It was more rapid than growth in global production which stood at an average of 7 percent between 1980 and 1997. Increased foreign direct investment will expand international production by' transnational companies to the extent that they comprise 3.4 trillion dollars and about 449,000 foreign companies. The amount of those companies' sales will be higher than foreign trade (global export) and has reached about 9.5 billion dollars. As quantity of foreign direct investment increased, its dispersion also increased. Share of less developed countries has increased from 14 percent in 1980 to 26 percent in 1997. However, corporations in industrial states are still the main sources of foreign direct investment.

Although, foreign direct investment in less developed countries has doubled since the middle of the 1980s, industrial states absorb a higher share of it. However, this is changing because less developed have become attractive grounds for foreign investment. Distribution of foreign direct investment among less developed countries is not even. In recent years, less developed countries in Asia, Latin America and the Caribbean region, as well as Africa have accounted for 22 percent, 14 percent, and 1 percent of foreign direct investment respectively.

Less developed Countries and FDI

Subsequent to debt crisis in less developed countries and limitations considered for granting facilities to those countries by international banks in early 1980s, competition for the attraction of foreign direct investment has increased. For those countries, foreign direct investment is a main source of private sector's funds. Advantage of this source over other foreign sources of investment is that in foreign direct investment, investors follow long-term productivity in production activities. Yet, borrowing from foreign banks and portfolio investment are directed to activities which are not generally controlled by banks or portfolio investors and are mainly used for achieving short-term profitable goals. They are affected by various factors including interest rate or group decisions. This difference was evident in the course of the Southeast Asian crisis in 1997. In that year, foreign direct investment flow to five countries that were hit more severely by that crisis was positive in every instance and only reduced a little, while flow of borrowing from banks and portfolio stocks reduced rapidly and was even negative in 1997.

Apart from investment in production tools and capital formation, foreign direct investment is a way for technology transfer in production, promoting skills, as well as access to international marketing networks. The more suitable is domestic ambience for hosting foreign direct investment and the more domestic corporations are able to avail of capabilities of foreign companies and spillovers, the higher will be their efficiency and competitive power.

Policies adopted by host country play a remarkable role in attracting foreign direct investment. In view of potential role of foreign direct investment in accelerating economic growth and changing the situation of less developed countries with regard to foreign direct investment attraction, those countries try to improve basic factors affecting foreign direct investment attraction. The following table which is based on annual investment report by UNCTAD displays basic determinants affecting foreign direct investment in host countries. Adopting liberalization policy and removing barriers will pave the way for the attraction of the foreign direct investment. Frame of foreign direct investment attraction policy in the table is only one factor affecting the location of investment. Other factors including multiple policies affecting FDI such as core FDI policies and trade policies can play a remarkable role in attracting foreign investment. In addition, international companies have entered into many bilateral investment treaties and double taxation arrangements. In 1997, 1,513 bilateral investments and 1,794 double taxation contracts were implemented. After determining frame of FDI policies, countries demanding foreign direct investment are trying to meet standards to facilitate trade. They include the growth of investment, investment incentives, and services provided after investment. After-investment services are important because they encourage repeated investment by current investors and make the host country famous, thus paving the way for new investments. In addition, financial motives are effective in attracting investment. Economic factors are the main factors that locate foreign direct investment. Various reasons, including access to market, resources, assets, and higher productivity; prompt corporations to embark on foreign direct investment. This table suggests factors that affect each and every of those motives.

Host Country Determinants of FDI

Host country determinants	Type of FDI classified by motives of transnational companies	Principal economic determinants in host countries
I. Policy framework for FDI • Economic, political and social stability • Rules regarding entry and operations • Standards of treatment of foreign affiliates • Policies on functioning and structure of markets (especially competition and M & A policies) • International agreements on FDI	A. Market-seeking	• Market size and per capita income • Market growth • Access to regional and global markets • Country-specific consumer preferences • Structure of markets
Privatization policy trade policy-(tariffs and NTBs) and coherence of FDI and trade policies tax policy II. Economic determinants III. Business facilities • Investment promotion (including image building and investment-generating activities and investment-facility services) • Investment incentives	B. Resource/asset-seeking	• Raw materials • Low-cost unskilled labor • Skilled labor • Technological, innovatory and other created assts (e.g. brand names), including as embodied in individuals, firms and clusters • Physical infrastructure (posts, roads, power, telecommunication)
• Hassle costs (related to corruption, administrative efficiency, etc.) • Social amenities (bilingual schools, quality of life, etc.) • After- investment services	C. Efficiency-seeking	• Cost of resources and assets listed under B. adjusted for productivity for labor resources • Other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products • Membership of a regional integration agreement conducive to the establishment of regional corporate networks

Foreign Direct Investment in Iran

Foreign direct investment in Iran was imposed by great powers in such fields as natural resources and mines until 1931 which depicted a negative picture of foreign investment within the country. Approving a law for encouragement and attraction of foreign investment in 1955 was a turning point in the history of foreign private investment in Iran. Its implementation in 1956 increased the number of companies registered with foreign private stockholders. A center for encouragement and protection of foreign investment was established on May 7, 1962. From 1956 to 1978, 1,641 Iranian companies with foreign private stockholders were registered in the country with the highest figures pertaining to 1975 at 498 and 1976 at 338 companies. After 1978, foreign investment took a downturn to the extent that during the recent years and despite the ratification of a law for the encouragement and protection of foreign direct investment, no new investment has been made in Iran, while existing investments are on the rise. A report by the Investment Office has put the number of all foreign investment, covered by the Trade Law, at 1,853 by June 15th, 1981. Trade cards pertaining to 177 companies were extended in 1981 and 1982. Out of those 177 companies, 133 companies are active in trade, 13 companies in chemistry, and 13 other companies are engaged in production of paper, cellulose, food, and textiles. There are a number of reasons behind Iran's inability to attract foreign direct investment which include:

Fundaments and barriers to foreign investment in Iran

According to Article 81 of the Islamic Republic of Iran's Constitution granting concessions, establishment of companies and institutes active in trade, industry, agriculture, mines and service sector to foreigners is absolutely forbidden. This article is considered as a major impediment to attraction of such investment. The new law for encouraging and protecting foreign investments did away with ambiguities surrounding this constitutional article. In Paragraph D, Article 2 of Foreign Investment Encouragement and Protection Act, share of foreign investments in economic sectors and in every field is, respectively, 25 percent and 35 percent. As a result, foreign investor account for 100 percent of the needed investment in a special production or service activity should that investment does not exceed 25 percent of that production or 35 percent in a single field. A note under Article 2 of the new act, like the previous ratification which dates back to 1931, bans possession of immovable property by foreign nationals which is bugged by legal ambiguities. At the same time, transfer of foreign investment shares to a third party, according to Article 10 of the same act, would depend on the approval of a board assigned by the government after confirmation by Minister of Economic Affairs and Finance. The most important part of that act, which is source of concern about the attraction of foreign investment, is Article 19 according to which settling disputes between the Iranian government and foreign investor about bilateral commitments should be done at the Iranian courts. Existence of the dispute settlement centers like CISID which is affiliated to the World Bank has paved the way for negotiations between foreign investors and host countries on the basis of international laws. If Iran acceded to the CISID and Article 19 is canceled, all concerns on the part of foreign investors about investing in Iran will be dismissed.

Cultural and social barriers

As of the elements discouraging foreign investment in Iran, cultural and social constraints can be mentioned. Lack of a suitable technology culture, absence of efficient information and communication networks, lack of incentives for hard work among people, lack of institutionalization of law among people, burdensome bureaucracy, traffic problems in major cities, etc., are major instances that have greatly reduced productivity in the country. Low productivity on the large and small scales indicates inability in making good use of available resources. Encouraging extravagance after oil price hike in 1974 was a major reason for wastage of rare resources. According to available statistics, about 30 percent of foodstuff in Iran is wasted which can be used to feed 15 million people. During ten years from 1989 to 1999, only 25 percent of permits issued for production and industrial activities were made operational and 75 percent were aborted due to various reasons. Spreading culture of optimization on large and small scales in the society would require scientific education and research from elementary school up to higher education. Another cultural barrier is the risk of spreading corruption. Preventing corruption and bribery in the society is an important issue which calls for due attention. Administrative corruption will discredit laws and regulations and lead to heavy personal and social costs. Encouraging brokers hip will paralyze domestic economy and prevent attraction of foreign direct investment. Another cultural impediment is inattention to the value of time and punctuality. Untimely discharge of goods and resultant waste of perishable goods, as well as prolonging customs and administrative formalities are some instances in this regard.

Economic conditions and barriers

Transnational companies have the right to choose when transferring their assets, techniques as well as managerial and entrepreneurship capabilities to other countries. They assess countries from all aspects to find a good place for investment in terms of their goals and priorities. One of the most important assessment criteria for foreign direct investment is economic conditions of the host country. According to UNCTAD's table on foreign direct investment, international corporations are divided into those seeking market, those seeking resources or assets, and those seeking efficiency. Corporations seeking market, pay the highest attention to size of the market and per capita income, market growth, as well as access to regional and global markets. Iran, therefore, is a good option for investment due to its great population, oil wealth as well as geographical and strategic position in the neighborhood of Central Asia and the Persian Gulf. While it comes to market structures, protectionism as well as 'monopolies in some industries, in addition to lack of active and efficient money and financial markets are major problems that should be solved.

For corporations seeking resources and assets, Iran can be a good place because foreign investors can take advantage of inexpensive raw materials and labor force as well as skilled manpower. Yet, the country is not as much attractive in terms of technical assets, innovation, invention, creativity, as well as such infrastructures as roads, ports, communications and telecommunication. Corporations that seek efficiency will not find Iran a suitable place for investment. If the costs of production resources and assets are adjusted for efficiency of manpower, the high cost of production in Iran will become evident. According to statistics, every 1,000 tons of steel is produced by one person in Japan, while the corresponding figures are 3-5 persons for Western Europe, 10 persons in Eastern Europe and 10 persons in Iran. High price of steel in Iran is about 1.5 times of its price in international markets. At the same time, energy is inexpensive in Iran to the extent that it is used to make up for low efficiency of manpower. According to available figures, useful work at Iranian offices is ineffective. Low productivity means high cost price and low quality of production. Price and quality are main factors that determ1ine comparative advantage of a company. Macroeconomic policies of a government undoubtedly play an undeniable role in the attraction of foreign direct investment. Suitable monetary, financial and foreign exchange policies adopted by the government to stabilize economy and curb inflation, latest electronic banking and financial services, trade liberalization policies, speeding up privatization drive, efficient taxation policies, reviewing labor law and establishing economic security are major prerequisites for the attraction of foreign direct investment.

Historical and political barriers

Economic activities of the private sector depend on security and rule of law. Apart from foreign elements, domestic elements such as despotic rule and political stability as well as rapid change of governments, social unrests and lack of civil institutions have been historical causes for instability of private ownership. James Frazer who visited Iran in the early years of Qajar Dynasty has written that the main barrier to Iran's economic prosperity is insecurity which results from the nature of governments as well as revolutions that such governments are always exposed to. This situation bars people from embarking on industrial production because nobody will produce a good which will be shortly lost. In another instance, Gennan Henry Rene has also written that there is no nation in the world which is afraid of showing its wealth as much as the Iranians because they are always scared of the government and they like to keep their capital at hand and hide it in a safe place. Lack of judicial security has prevented capital owners from establishing companies. Therefore, people's wealth has been converted to gold and jewels only to be hidden under the ground. Transactions are slow and sometimes, days after days, Iranians are just busy bargaining.

Historically speaking, insecurity has been a major barrier to economic Less developed of Iran. Doing away with historical problems that are rooted in the culture of a nation requires long-term cultural endeavors to make people aware of their rights and pave the way for the establishment of civil society. At present, in view of economic and political security, domestic investors have no concerns in this regard but negative propaganda outside the country and exaggeration about political disputes in Iran will discourage foreign investors. Understanding and coordination in political and international matters will increase political stability of the country and clear the way for the attraction of foreign direct investment. To assure foreign investors, many things should be done in various fields. According to the assessments of creditable international economic institutes, Iran's investment risk is one of the highest among many countries. Establishment of thousands of Iranian companies in Dubai during the recent years is an ominous sign of capital flight and high investment risk in Iran.

International Agreements on FDI

A major interest of international companies is to avail of facilities considered by international agreements. The World Bank established the International Center for Settlement of Investment Disputes (CISID) to promote international investments. Some 151 organizations representing 54 countries are members of the CISID. The center aims at providing facilities and guiding negotiations between foreign investors and host countries. Arbitration facilities provided by the CISID, support common forms of Investment. Apart from dispute settlement, the CISID is active in research and less developed consultation services as well as publication of books about active investment laws. Its publications include multivolume books about global laws on investment, investment contracts as well as a semi-annual law journal entitled *CISID* Review-Foreign Investment Law Journal. Another body launched by the World Bank to promote foreign investment was establishment of the Multilateral Investment Guarantee Agency (MIGA) in 1988. The main mission of the MIGA is to promote foreign direct investment (FDI) into less developed countries to help support economic growth, reduce poverty, and improve people's lives. The MIGA also helps national and private agencies which support foreign direct investment through their investment insurance plans. The agency has been designed to pave the way for sustained insurance of investment against non-commercial and political hazards in less developed countries, encourage foreign investment, and create investment opportunities in those countries. Comprehensive nature of the agency and support lent to it by developed and less developed countries has built up confidence of investors from various nationalities who try to invest in joint ventures in a less developed state. The MIGA provides technical assistance to investment promotion intermediaries in less developed member countries to enhance their capacity to provide investors with information and advice with the goal of reducing the transaction costs associated with site selection as well as helping new ventures get established.

Notes about Attracting FDI

Performance of foreign investors has had clear results and if a host country fails to delve into those results, investment can have adverse effects. Attraction of foreign direct investment in a country will only lead to technology transfer when it changes economic and social situation in the host country. As defined by Stephan Robock, technology is an ending source of knowledge, skill and tools for taking advantage of and controlling production factors. Its goals include production, distribution among consumers as well as maintenance of goods and services which are of economic or social demand. This definition covers not only economic, but also social goods. Today, less developed does not solely mean increasing economic production, but it means improvement in life quality. Therefore, when transferring technology, attention is also paid to such social sectors as education, health and public affairs. According to this definition, distribution factors can be as powerful barriers to less developed as shortage of production institutes, capacity for creating new technology, and maintenance of technology is. Technology transfer can empower recipient country and lead to the Less developed of new technologies.

Attraction of foreign investment into Iran should be accompanied with transfer of modem technology and creation of added value in the country. At present, added value of the industrial sector in Iran is very low and is about 0.3 percent of global added value while Iran enjoys 1.23 percent of Earth and 1.7 percent of world population. Technology is not a physical commodity to be transferred from supplier to consumer. Technology is a coherent body of knowledge which is transferred through a learning process. Technology transfer from one country to another is complicated, time-consuming and costly, even if it is being transferred from one unit of a transnational corporation (TNC) to another affiliated unit. Complexity and cost of transfer would depend on: 1) nature of transferred technology, 2) characteristics, capabilities, and goals of both parties, and 3) capacity for the attraction of economic and social sectors in the host country. Furthermore, the type of technology is instrumental during the course of technology transfer. Technology can be hardware or software. Hardware technology includes capital goods, technical features of know-how and other hardware assistance which is needed to take advantage of a certain technology. Software technology comprises marketing management, financial organizations, administrative techniques as well as computer programs. Technology transferred by transnational corporations can be front-end (state-of-the-art), or obsolete (old and outdated). Technology may be proprietary; that is, owned by certain individuals or organizations. It may be non-proprietary. This type of technology can be imitated through studying technical texts and hardware or through reverse engineering without legal bans. Reverse engineering is learning a competitor's technology by dismantling an existing product and reproducing its parts and construction to manufacture a replica. Industrial countries are pioneers in certain industrial fields. For example, the United States is a leader in computer technology while Germany and Switzerland are good in chemical and medicinal technology. At the same time, Europeans and the Japanese are skillful in making fuel efficient vehicles. After deciding about the needed technology and identifying leading countries in that technology, we must provide them with good conditions and pave the way for transfer of the most appropriate know-how. Creating good grounds inside the country and removing barriers can clear the way for the attraction of foreign direct investment.

In view of inefficient management of the private sector in Iran, domestic investors can avail of the existing capacities in foreign direct investment and can take advantage of their manpower as well as physical, financial and information capabilities to boost management capacities in the country. On the other hand, diversification of economic activities will reduce dependence on oil and increase non-oil exports. Foreign direct investment in oil is a different matter and cannot be viewed as a criterion for assessing Iran's appeal to foreign investors.

Conclusion

Growth of foreign direct investment in the past two decades and the notion that foreign direct investment will lead to technology transfer as well as enlistment of managerial and innovation capacities in the less developed countries has increased the share of transnational companies from international economic activities. As put by Mr. Michael Tocas, managing director of Iran-Germany Chamber of Commerce and Industries, foreign investment is like a stream of water which will easily change the course in the face of any barrier. Less developed countries have thought of many ways to remove barriers and attract foreign direct investment. In Iran, much emphasis has been put on the attraction of foreign direct investment over the past few years. Although efforts made to improve and amend foreign investment encouragement and protection laws have been useful and promising, overall performance of the country with regard to attracting foreign direct investment has not been satisfactory. According to the latest report issued by United Nations Conference on Trade and less developed in 1998, Iran accounted for only 0.085 billion dollars of foreign direct investment while corresponding figure for Saudi Arabia stood at 4.8 billion dollars. The figure also accounts for 0.1 percent of gross constant capital formation in Iran and 16.6 percent of the same in Saudi Arabia. Therefore, Iran needs suitable economic and social ambience. Adopting efficient macroeconomic policies, cultural changes as well as research on factors preventing the attraction of foreign direct investment are the requisites to enable us make the most of potential capacities in the country and overcome economic and social difficulties.

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