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Economic Globalization, Political Economy and Investment Risks in Developing Countries

Marzyyeh Atashgah

Candidate, Doctor of Laws
marzyyeh@gmail.com

Abstract: ***Background of the study: FDI, PFI, and BITs can facilitate foreign investors investing in developing countries to help economic development in the host country. However, in reality, developing countries have conditions that investors consider when making investment decisions. The aims and objectives: To identify investment risks in developing countries so that appropriate strategies are found to overcome these risks. Methods: The research carried out in this research is a library research method sourced from secondary sources. Results: Private foreign investors in developing countries face significant challenges, namely political instability, government policies, macroeconomic uncertainty, and acts of corruption from host countries. BITs provide vital legal certainty to create a safe and stable investment environment. Tax incentives benefit investors and host countries if solid and consistent laws regulate them. Conclusion: Foreign private investors face political instability, government policies, and corruption. BITs and tax incentives strengthen investment certainty.***

Keywords: Economic Globalization; Political Economy; Foreign Direct Investment FDI; Private Foreign Investment PFI; Bilateral Investment Treaties BIT, Investment Risks; Developing Countries; Risk Management

1. Introduction

In the last few decades, FDI has chosen to invest in developing countries to gain profits. According to Gottschalk, investing in developing countries can obtain higher profits than investing in developed countries because developing countries can diversify their portfolios, potentially reducing the risk of sure earnings due to a lower tolerance level for investors.[1] FDI is needed by developing countries to encourage economic growth, especially in developing countries, by contributing to capital formation and complementing domestic investment.[2] FDI is an effective means for developing countries to improve the economy globally so that by opening themselves up to foreign investment, developing countries can more easily access international markets, have sophisticated technology due to technology transfer, and good management of the knowledge provided by investors. FDI offers direct capital for economic growth and contributes indirectly, such as improving the quality of institutions in developing technology in the host country by providing more knowledge. More knowledge and development of local quality allow developing countries to maximize profits from FDI by having the proper policy framework. The positive impact of FDI on the economic sector of developing countries depends on the home country's ability to absorb new knowledge, affecting the quality of local resources in the host country.[3] Japan’s current African policy transforms Japan and Africa into modern economic partners. However, Japanese investments in Africa have received less attention than Chinese investments. It's competing with Chinese investments in the evolving political economy of Japanese investments in Africa. Japan is firmly committed to Africa and some Asian countries, including Bangladesh, to transform foreign aid into foreign investment. They aimed to promote private business partnerships through private investors in Japan.

This study aims to identify investment risks in developing countries, which are used to find appropriate strategies and examine the legal framework for protection to overcome these risks and attract the interest of foreign investors, making investment more profitable for both investors and the host country.

2. Literature Survey

FDI in developing countries has advantages for host countries because it can reduce unemployment by creating jobs and increasing the manufacturing and service sectors. Apart from that, FDI also involves the knowledge and competence of the workforce, which is expected to improve the quality of the population of developing countries. Currently, the UN is also promoting the use of FDI worldwide to help combat climate change.[4] Often, developing countries need help with the cost of developing infrastructure such as roads, bridges, health services, and education, which supports attracting foreign investors' interest in helping develop the economy in their country. Thus, PFI is needed to bridge the gap between infrastructure and economic development by facilitating collaboration between the government and the private sector in inefficient infrastructure development, which is very useful for developing countries. In other words, PFI reduces infrastructure gaps and can help long-term economic growth in the host country.[5] BITs (Bilateral Investment Treaties) are essential in international investment activities. They are designed to provide standards of treatment that protect investors, such as opposing expropriation or nationalization, settling disputes between investors and the state, and other privileges. BITs can also allow investors to file claims before international courts for violations of the provisions of BITs, thereby providing legal reassurance to foreign investors.[6]

Although FDI, PFI, and BITs can facilitate investment in developing countries, developing countries have conditions

to which foreign investors should pay attention before investing. One tangible example is Nigeria.

Nigeria is one of the target countries for investors because it has the 10th largest oil reserves in the world and the 9th largest gas reserves in the world. Nigeria is also a strategic place for conducting global trade routes.[7] Despite this, Nigeria is not free from economic problems in its country because, in 2020, world oil prices experienced instability due to COVID-19, so world oil demand experienced a decline. In response to this phenomenon, the government made a policy of eliminating fuel subsidies in Africa, increasing fuel prices and leading to inflation. This inflation made investors shift their assets to foreign currencies, which resulted in Nigeria experiencing a foreign exchange shortage. It was reported that Nigeria's foreign exchange decreased from $47 billion in July 2018 to $35 billion in March 2023. Nigeria also experiences economic disparities due to poor infrastructure, high levels of corruption, population growth, and weak macroeconomics.[8]

Nigeria has high-tariff protectionist trade, so the availability of foreign exchange for imports is limited, making access to foreign currency difficult and an obstacle to business.[9] This protectionist trade is carried out to reduce dependence on imports so that local communities support local production. As a result, many companies in Nigeria need help maintaining smooth operations and increasing operational costs in the global market. Apart from that, Nigeria has issues with regulatory uncertainty and limited domestic gas supplies, resulting in problems with electricity supply, which weakens the confidence of foreign investors.[10]

In this era of globalization, many developing countries compete to attract foreign investors to invest in their country; for example, in Ethiopia, where the local government is implementing a tax relief policy, considered one of the most efficient strategies for attracting investors. However, most developing countries have several obstacles, such as poor governance, high corruption levels, which tend to involve tax evasion, and weak government design. The Ethiopian government created excessive tax incentive policies to attract investors, which caused their country to "suffer" because the tax structure was less integrated.[11]

3. Problem Definition

This study also focuses on identifying investment risks in developing countries. Still, it proposes steps to adapt existing frameworks and examines the legal framework in providing international business protection so that stakeholders can improve and utilize it in their jurisdictions. This study also focuses on the prerequisites for technological securities applicable to investors before investing in certain countries. The following are the problem formulations of this research:

1) What are the risks for foreign investors investing in developing countries?
2) What are the government's measures to protect innovation and foreign investor capital?
3) Are the tax incentives offered by developing countries profitable for foreign investors?

4. Methodology / Approach

The research carried out in this research is a library research method originating from secondary sources. Secondary sources come from textbooks, journal articles, and the internet related to investment risks in developing countries. This risk can be used to find strategies and knowledge for investors before investing abroad, especially in developing countries. Apart from that, this research can be used as an evaluation tool for developing countries to increase their attractiveness and increase foreign investors' interest in investing.

5. Results & Discussion

5.1 The risks for foreign investors investing in developing countries

Private foreign investors in developing countries face various challenges in making investment decisions. These countries are filled with uncertainty due to political instability, government policies, macroeconomic uncertainty, and corruption from host countries, making it difficult for foreign investors to predict the consequences. [12] This affects their activities. Businesses in the country include high production, manufacturing, and service costs.

Political instability is usually caused by significant or democratic changes in government, revolution, or war that may disrupt ongoing projects, for example, the physical destruction of assets and infrastructure used in production, the composition of the workforce, and a reduction in income due to a decline in demand for goods and services.[13] Political instability is closely related to the high rate of corruption in a country, where a less stable government will more easily commit acts of embezzlement, demand effects, and corruption than countries with a stable government.[14] Corruption is an act of abuse of public office aimed at achieving personal gain, especially if there is an opportunity to declare oneself illegally.[15] This is due to a lack of internal supervision and control, which gives perpetrators space to take advantage of this situation. The demand effect also plays a role in that they have a greater incentive to secure short-term profits before their position is threatened by political instability. This creates a high-risk investment environment for investors.

Corruption can distort growth-promoting public spending, such as education and health, into other expenditures that do less to increase host country productivity. In other words, acts of corruption will tend to increase the amount of public investment. Still, investment quality will decrease, for example, due to bad roads or inadequate electricity supply. Corruption and instability in economic policies will also tend to lead to non-transparency actions by the government towards foreign investors, thereby creating uncertainty in the business world. [16]

A clear example of political risk for foreign investors is that in Kenya, it is reported that companies or investors often experience demands for bribes and informal payments to "get things done" in Kenya. [17] In Ghana, there are also

high corruption cases and limited electricity supply, which causes high operational costs for businesses.[18]

The quality of the host country's infrastructure determines the efficiency of the production process, which is closely related to the performance and quality of the company, as well as the quality of the use of resources such as capital and labor.[19] For example, the Philippines tends to have high electricity costs, slow broadband connections, high levels of corruption, policies that change frequently, and a complicated judiciary due to the intervention of bribery. This dramatically influences investors' interest in investing in the Philippines.[20]

Inflation in developing countries also influences foreign investors' decisions because an excellent macroeconomic environment will increase the attractiveness of the host country's market with company efficiency and performance. For example, Zimbabwe is experiencing fantastic inflation and public debt, inadequate infrastructure, and a lack of electricity. This fantastic inflation causes an increase in company operational costs so that investors do not get big profits; Zimbabwe has weak laws, so property rights are considered fragile. This has a very significant impact on the decisions of foreign private investors.[21]

Japan considers Africa a high-risk and dangerous region due to political and regulatory instability and health risks in Africa, plus the frequent security threats that occur in Africa. Political instability often becomes an obstacle for Japanese investors due to the impact of suddenly changing policies and the need for adequate legal protection. Japanese investors usually feel security threats, such as armed conflict and crime, strengthening Japan's view that investment in Africa carries high risks.[22]

Japanese investment in Africa has received little attention from Africa, and even though its numbers are increasing, this creates little competition with Chinese investment in Africa. There is a need for more attention from Africa towards Japanese investors because it is considered that they need to aim to invest fully. Still, political interests need to guarantee sustainable economic development in Africa. This is characterized by Afro-Japanese bilateral investment (BITs), which has stagnated for over three decades. In contrast to investors from China, who receive more attention from Africa because they often offer infrastructure investment, Africa still needs better infrastructure. This creates the view that Chinese investment is more focused on sustainable economic development in Africa. In response to this situation, Japan is developing a sustainable and transparent strategy by enhancing diplomatic relations and economic cooperation with African countries to create a better investment environment for Japanese investors by strengthening the BIT framework and providing technological support in African development projects.[23]

5.2 The government's measures to protect innovation and foreign investor capital

International Investment Agreements (IIAs) are designed to help establish a stable and profitable investment environment by creating clear policies to protect foreign investors and minimizing political risks, such as sudden policy changes, so that foreign investors can establish investment activities in the host country.[24] IIAs allow foreign investors to access international courts to increase their confidence because they receive guarantees of protection from violations of agreements that have been made, such as non-payment to investors, withdrawal of investment permits by the host country, or denial of justice.[25] IIAs often do not address social issues such as environmental or employment issues; instead, they only help create a conducive atmosphere for investment flows. This is because most social problems are not legally binding but are only declarative.

In addition, the World Bank designed Bilateral Investment Treaties (BITs) to protect the rights of foreign investors but not burden them with obligations.[26] BITs provide a consistent and transparent legal framework in international investment activities to ensure that foreign investors receive treatment, fairness, and equality in the host country. In other words, BITs contribute to foreign investors' confidence in investing abroad, especially in developing countries, with more vital legal certainty, thereby creating a safer and more stable investment environment in developing countries.

The importance of BITs in attracting foreign investors into the host country must be addressed; India initiated the BITs program in 1994 to promote and protect the mutual investment base of investors. According to the Indian Ministry of Finance, BITs are carried out to increase investor comfort because they guarantee minimum standards in everything and provide justice for disputes with host countries.[27] BITs offer various benefits to the investment climate because these agreements provide vital protection for foreign investors and can access a neutral dispute resolution mechanism. This gives investors a sense of security when allocating their capital to projects in India, which can ultimately drive economic growth and job creation. BITs, in setting minimum standards that host countries must comply with, are carried out to prevent discrimination against foreign investors and ensure that foreign investors are treated the same as domestic investors. The United States government launched several investment strategies for Africa, including efforts to strengthen development-focused BITs that receive assistance from the United States to facilitate more excellent foreign investment flows. America also negotiates BITs with countries with high political risk profiles, such as Nigeria and Angola. By strengthening the BIT, the United States seeks to provide stronger legal guarantees for foreign investors to increase foreign investors' confidence in investing in Africa. The United States also provides the African Doing Business Facility, which aims to identify countries undertaking reforms to improve their business climate by conducting evaluations to create a more conducive business environment. The United States is also working with large American companies to promote investment in Africa that brings capital and transfers technology and knowledge to develop local quality.[28]

In recent years, many African countries have carried out aggressive business climate reforms to attract foreign investors to their countries. Doing Business Indicators, The

World Bank reported that in 2009, more than 60 percent of African countries had implemented business climate reforms, one of which was Rwanda, which was the most reformed country among other developing countries throughout the world, even though Africa remains one of the regions most at risk in business activities. Reform steps include introducing laws protecting investor rights and providing guarantees against legal injustice. In creating a stable and safe business environment, we increase investment protection and reform the business environment in target countries, especially countries with weak institutions and high political risks. These reforms include improving regulations, simplifying business processes, and increasing bureaucratic efficiency.[29]

5.3 Are the tax incentives offered by developing countries profitable for foreign investors?

Countries, especially regions with low growth rates and high unemployment, promote investment to foreign investors by creating incentive policies such as investment allowances, cheap labor, land allocation, resource procurement, land allocation, and tax incentives. Tax incentives can take various forms, such as tax reductions, tax credits, tax exemptions, tax refunds, and tax holidays. Developing countries often offer tax incentives or tax holidays to companies to attract foreign investors by exempting corporate income or income tax for up to 10 years for certain types of investments that have been determined. This intensive aims to create a more attractive and competitive investment climate to encourage FDI in developing countries. In addition, tax reductions, tax credits, tax exemptions, and reduced tax rates for research and development (R&D) activities are designed to reduce the initial costs and risks foreign investors face.[30] Tax incentives can encourage various sectors that are very important for developing countries, such as manufacturing, renewable energy, infrastructure, and technological development, which can help increase profits for host countries and investors.

However, tax incentive policies can also be dangerous for host countries and investors if they are not careful in designing them because they can result in loss of income and increased administrative costs, thus tending to give rise to acts of corruption to take advantage. The use of tax incentive policies must be balanced so that they are mutually beneficial for both the host country and foreign investors. In other words, tax incentives must be created in a structured manner and included in clear tax laws and not ad hoc.[31] Many developing countries use tax incentives excessively to attract investors and are not regulated by solid laws. For example, Ethiopia suffered from reduced state revenues and gave rise to acts of corruption. High levels of corruption tend to lead to tax manipulation in which part of the nominal tax is stolen. This raises doubts from foreign investors about investing in Ethiopia.[32] Based on this case, tax incentives can benefit both investors and host countries if the policy is designed in such a way and regulated in law that is strong in its implementation, as well as considering strategic sectors and monitoring and evaluation in designing tax incentive policies. Policies considering strategic sectors can significantly impact the host country's economy; for example, incentives focusing on the technology, infrastructure, and manufacturing industries support sustainable economic development. Tax incentive policies must also be designed with high transparency and accountability so investors can easily understand them.

6. Conclusion

The current era of globalization shows the importance of foreign investment (FDI), and global production is increasingly spread geographically because it can increase global competition as marketing speed is the key to achieving competitive advantage where companies must be able to rely on resources and competencies that are widely spread across the world. The whole world. FDI contributes to the development of the host economy by transferring technology and providing more knowledge to the people of developing countries to develop local quality and maximize the benefits of FDI by having the proper policy framework. Political risks are always a concern for foreign investors before investing because political instability tends to give rise to acts of corruption, lack of transparency from the government towards investors, create uncertainty in the business environment, and hampers business operations, which will be detrimental to investors. Developing countries often use tax incentive policies to attract FDI. This policy can benefit host countries and investors if strong laws are consistently implemented to regulate it. There are several suggestions from the author that need to be taken to overcome or minimize investment risks in developing countries, including:

1) The government must create a more stable economy by making consistent and transparent policies to reduce market uncertainty, which will significantly influence foreign investors' confidence in the host country.
2) Government policies must be attentive to a pro-business culture and easier to understand to make it easier for businesses to operate in the host country. They must also provide solid legal protection to protect investors' rights and ensure investors receive the same treatment as the host country before the law.
3) The government must consider the country's conditions when making tax incentive policies so that they are balanced. Unbalanced and excessive tax incentive policies tend to lead to acts of corruption due to reduced state revenues. The rate of corruption in a country dramatically influences the decisions of foreign investors.

7. Future Scope

This research focuses on the risks for private investors in investing in developing countries. In the future, the scope of this research could be expanded by exploring how current technologies can be used to increase the transparency, efficiency, and security of foreign investment in developing countries. This makes it much easier for foreign investors to identify risks before investing in developing countries, speeds up the investment process, and facilitates more effective communication between investors and host governments.

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