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Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues
Editor-in-Chief: Karl P. Sauvant (karlsauvant@gmail.com)
Managing Editor: Chioma Menankiti (clm2249@columbia.edu)

No. 407 April 14, 2025

FDI and the digital economy: the need for policy alignment

by
Xavier Forneris*

To achieve greater prosperity, many countries have embarked on a march toward the digital economy, or "digitalization".[1] The journey is challenging, especially for developing economies with less advanced technology, fledgling private sectors and limited fiscal space for public investment.

FDI can help all economies tackle the challenge by bringing the combination of capital, know-how, technology, and infrastructure needed. Its catalytic power can be particularly helpful for developing economies, as illustrated by the transformation of Asian nations into powerful export-oriented economies, in a large part through efficiency-seeking FDI. A similar phenomenon could help many countries to become "digital economies". There are signs that this is happening, with Asian economies rapidly becoming major exporters of digital services or of manufactured goods with digital economy applications.

But for FDI to play its "transformation magic", there are pre-requisites in terms of policy and promotion. First, there needs to be clarity of vision: each country needs to clearly define what types of digital activities it wishes to attract and reflect these choices in its FDI promotion strategy. Promoting without a clear strategy is akin to driving without a direction. Second, FDI policies must be aligned with the defined strategy. Two first policy areas to consider are investment *entry* and *incentives*: the former must not impede FDI entry into digital sectors, and the latter must target FDI into these sectors.

Investment entry. Many barriers still limit foreign participation in digital economy sectors.[2] Typical barriers take the form of foreign equity ceilings or prohibitions to invest in a given activity.

Both are still pervasive, as revealed by the OECD FDI Restrictiveness Index, a measure of how open or closed 69 countries are to FDI in 22 sectors. The index shows that countries that are more closed to FDI in general also have higher restrictions in digital-related sectors. In other words, their "digital entry score" tends to be worse than their overall score. Countries can accelerate digitalization by reducing entry restrictions to FDI in digital technology sectors. Relevant entry reform examples include the following:

- To strengthen its regional position as a digital hub, Kenya has removed the 30% domestic equity requirement that was imposed on non-Kenyan ICT companies.
- India, which also aims to become a digital powerhouse, now allows 100% foreign investment in telecom services under the "automatic route" (not subject to screening).
- China now allows 100% foreign ownership in value-added telecommunications services (e.g., electronic data interchange, networked electronic devices data processing) within pilot areas of Beijing, Shanghai, Hainan, and Shenzhen.

Another type of entry barrier that is of growing concern is screening based on "national security". The extension of national security reviews from FDI in the defense sector to any FDI that entails "critical technology or infrastructure" naturally exposes digital FDI to increased scrutiny. However, this is not an area very likely to be reformed in the current geo-political climate.

Investment incentives. Countries pursuing a digital economy must also align their incentive regimes to target FDI in relevant sectors. But many countries do not have "digital investments" as priority sectors for incentives. The advice here is not to provide *more* incentives but to use more *targeted* incentives. This should be done with careful consideration to costs and transparency. Incentives also need to align with new international tax standards such as those on "Base Erosion and Profit Shifting" (BEPS). Recent examples of specific incentives to encourage FDI in digital sectors include:

- Mauritius implemented an 80% income tax exemption for companies holding a "robotic and AI-enabled advisory services" license.
- Belgium adopted a "thematic" tax deduction of 40% to support digital investments.
- Costa Rica's new strategic plan to become a hub for the semiconductor industry in the region includes financial and fiscal incentives targeting research and development that will be aligned with BEPS.

Building the digital economy requires more than sound entry and incentives policies.[3] Countries will also have to invest in digital infrastructure and skills development, for instance.[4] However, FDI can help accelerate the transition. Having a clear promotion strategy operationalized through sound entry policies and targeted incentives increases the chance of success.

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[*] Xavier Forneris (xforneris@worldbank.org) is a Senior FDI specialist in the World Bank and also serves as Investment Climate Coordinator in West & North Africa. The views expressed here are the author's own. Peer reviewers Andreas Dressler, Nazareth Satyanand and Matthew Stephenson are thanked for their helpful comments.

[1] "Digitalization" here is used interchangeably with "digital economy" and does not refer to the use of technology to automate investment procedures and other G2B services (e.g., company registration, tax payments). The digitalization of investment processes pertains to the investment facilitation agenda addressed in other *Perspectives*.

[2] By "digital sectors" we mean a heterogeneous range of economic activities, including telecom services (fixed, mobile, internet), software and IT services, manufacturing of electronic devices and components, data centers, cloud computing, and artificial intelligence.

[3] See, for instance, https://www.weforum.org/publications/digital-fdi-policies-regulations-and-measures-to-attract-fdi-in-the-digital-economy/.

[4] These investments can in themselves be "incentives" for foreign investors to come to countries offering them.

For further information, including information regarding submission to the *Perspectives*, please contact: Columbia Center on Sustainable Investment, Charles Denis, at cd3427@columbia.edu.

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