Foreign Direct Investment and Economic Development
What Do the States Need To Do?

Xiaolun Sun

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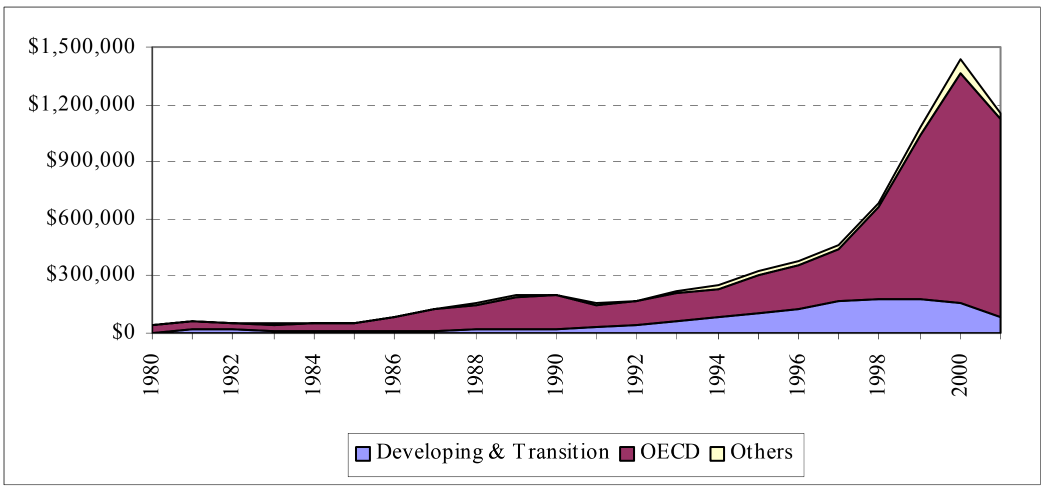
I. The Salient Facts of FDI

1. In this era of increasingly globalized world economy, FDI is a particularly significant driving force behind the interdependence of national economies. Even though most of the FDI flows has always concentrated in the developed countries, its importance is undeniable for developing countries as well (Figure 1). As shown in Table 1, between 1980-2000, while the aggregate wealth of the developing world nearly quadrupled and its total trade volumes rose more than five folds, FDI flows into developing countries grew by over 18 times. Through private direct investments, developing countries are participating more than ever before in the global production network.

Figure 1: FDI Flows in the World (US$ millions)



Source: IMF International Financial Statistics, 2002.

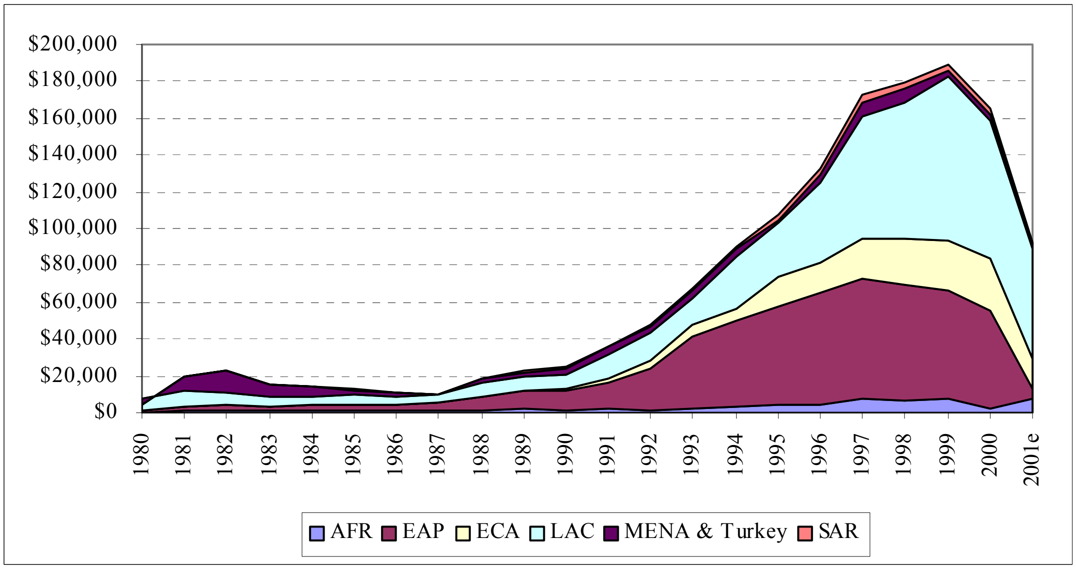
Table 1: Growth of Income, Trade, and Investment in Developing Countries
(Ratio of the two periods)

	1990/1980	2000/1990	2000/1980
Gross National Income	2.2	1.62	3.65
Export	2.0	3.03	6.2
Import	1.8	2.81	5.14
Aggregate resource flows	1.22	2.75	3.77
Private flows	.92	5.51	5.1
FDI flows	2.48	7.48	18.58

Source: World Bank, Global Development Finance, 2002.

2. However, this extraordinary phenomenon is not unfolding equally in all developing countries. During the last two decades, as FDI inflows to the Middle East and Northern Africa region stagnated, those to East Asia rose by 40 times. More remarkable still is the Eastern and Central Europe region, which attracted 42 times as much FDI in 2000 as it did just after the fall of the Berlin wall. (Figure 2.)

Figure 2: FDI Flows to Developing Countries (US$ millions)



Source: IMF International Financial Statistics, 2002.

3. As a result, the regional distribution of FDI flows changed substantially over this period. Once a leading destination of the world's private capital, the Middle East and Northern African countries hosted less FDI than the sub-Sahara African countries by the late 1990s, while the weight of East Asia rose dramatically since the late 1980s. (Table 2A.)

Table 2: Evolution of FDI in Developing Countries

	A. FDI Distribution (%)				B. Per Capita FDI (US$)			
	1980s		1990s		1980s		1990s	
	Early	Late	Early	Late	Early	Late	Early	Late
AFR	6.0	8.8	4.0	3.9	2.7	2.9	4.2	10.6
EAP	15.3	40.2	48.7	37.3	1.8	4.0	17.8	34.2
ECA	0.1	0.6	8.6	13.2	0.1	0.3	12.6	54.8
LAC	35.4	38.2	29.8	39.8	16.9	14.1	38.4	137.5
MENA	42.5	10.1	7.4	3.5	32.5	5.7	12.7	16.8
SAR	0.6	2.1	1.5	2.3	0.1	0.3	0.8	2.9

Source: World Bank, Global Development Finance, 2002.

4. Such an overall picture changes once again when the sizes of the regions are taken into account. On a per capita basis, the achievements of Latin American and Caribbean countries over-shadow those of all other countries, while the performance of countries in South Asia, though improving, still lags far behind. (Table 2B.)

5. What these basic facts tell us is that more than any other economic forces, FDI is driving the process of globalization by creating an increasingly tighter global production network. However, there are great discrepancies in the extent to which countries take part in this network. Not only significant gaps exist between developed and developing countries and among the different regions of the developing world, large and increasing disparities prevail even within the same region. (Table 3.) This phenomenon leads us to many questions: What are the roles of FDI in economic development? What determines the size and location of FDI flows? And what the states can do to reap the benefits of FDI while avoiding its negative impacts in this globalized world?

Table 3: Standard Deviations in FDI Flows within Each Region (US$ millions)

	1980	1985	1990	1995	2000
AFR	304	302	301	366	318
EAP	214	392	1,014	7,934	9,010
ECA	-	-	68	1,120	1,960
LAC	485	463	555	1,919	6,329
MENA	725	258	446	544	661
SAR	26	47	95	760	790

Source: IMF International Financial Statistics, 2002.

6. This paper attempts to provide some insight to these questions through a brief review of the existing evidence on FDI. The role of FDI in economic development is the center of the discussion and is analyzed in depth in the next section. Both its positive and negative impacts are examined, as well as the channels through which FDI interacts with local economies. The paper then reviews the vast empirical evidence on the determinants of FDI flows, which provides guidance on the pre-conditions that the states need to create to draw out the positive forces of FDI and to prevent its negative effects from harming their economies.

II. The role of FDI in Economic Development

7. Economic development is an all-encompassing concept. It centers on economic and social progress, but also entails many different aspects that are not easily quantified, such as political freedom, social justice, and environmental soundness.[1] Without a doubt, all these matters combine to contribute to an overall high standard of living. However, empirical evidence has amply demonstrated that all these varied elements of economic development correlate with economic growth. That is, as a general rule, countries with faster economic growth have more rapid improvement in health and education outcomes, progressively freer political system, increasingly more equitable distribution of wealth, and enhanced capacity for environmental management. Therefore, while economic growth does not bring about automatically other aspects of social, institutional and

[1] The United Nation Charter of 1944.

environmental improvements, without economic growth, there is limited prospects for such achievements.

8. In this context, the paper examines the role of FDI in economic development as a key ingredient for successful and sustainable economic growth and as part of a mechanism to social development. This section of the paper aims to highlight the most important channels through which FDI makes a significant and irreplaceable impact on the economic development of the host countries. At the same time, it is important to recognize that, like all things, FDI is not all good no bad. A separate discussion is devoted to the potential negative impacts of FDI flows on host economies.

A. An Impetus to Economic Growth

9. The potential for fast income growth has expanded drastically over time. Before the industrial revolution, it took European countries some 350 years for income per capita to double. As the industrial revolution accelerated in the 19th century, Britain, the lead country, was able to double its per capita income in just over 60 years. After the World War II and especially towards the end of the twentieth century, many developing countries, such as Japan, Botswana, Chile, Ireland, and the high performing East Asian economies, managed to double per capita income in less than 10 years. (Table 4.) For the first time in history, it is now possible for a poor person from an under-developed country to rise from poverty to a reasonably comfortable life within a single life span.

Table 4: Time Needed to Double Income

Pre-Industrial Revolution	350 years
Britain, 1st Industrial Revolution	175 years
Britain, mid 19th Century	65 years
Fast developers, post World War II	10 years or less

Source: Crafts (2000).

10. Just what is it that makes such rapid progress possible? Economic studies offer many potential explanations. According to one recent growth theory, long term economic growth can be explained as the combination of growth in its sources, i.e. the increases in factor inputs (capital and labor) and in total factor productivity (TFP), which reflects technological advances and other efficiency improvements in resource utilization.[2] In this "endogenous" growth framework, FDI has shown its ability to contribute significantly to all three components of growth: FDI increases capital stock, boosts human capital accumulation (though usually unmeasured in labor stock), and speeds up technological advances in host countries. Nevertheless, the most direct impacts of FDI on host economies are through its role in the accumulation of investment

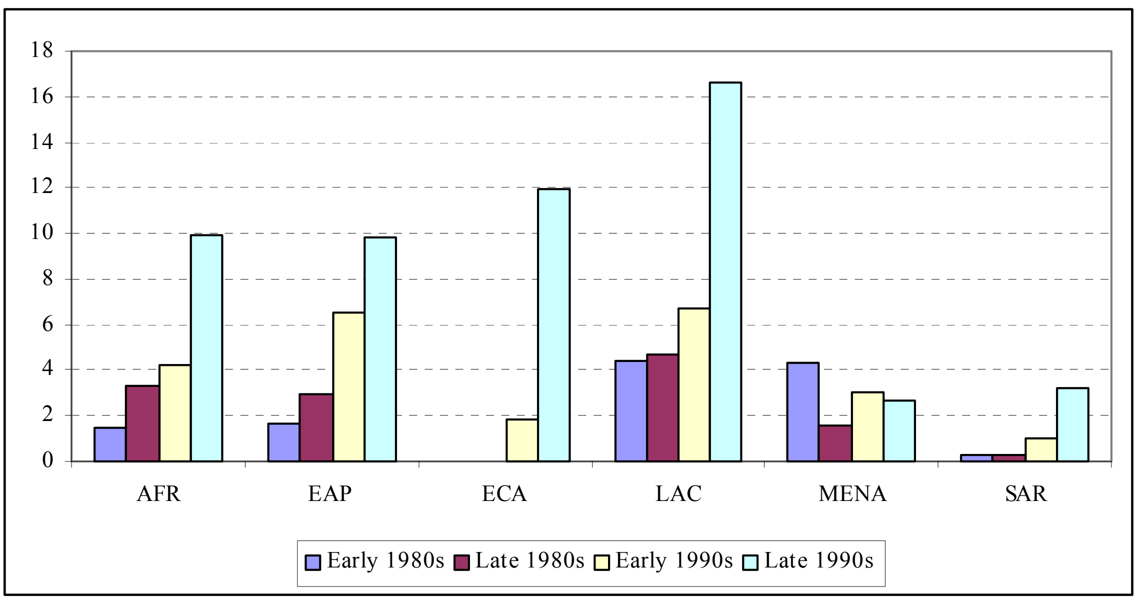
[2] More details on growth accounting theory can be found in Maddison, A. (1987), "Growth and slowdown in advanced caoutakust ecibinues: techniques of quantitative assessment," *Journal of Economic Literature*, Vol. 25; and Barro, R.J. (1998) "Notes on growth accounting," NBER Working Paper No. 6654.

capital and the growth of TFP of the recipients. These two impacts are discussed separately below.

1. FDI and Capital Formation

11. From the Golden Age investment boom after World War II to the East Asian economic miracles in the 1980s, there is ample evidence to demonstrate that investment is a key ingredient to sustained growth. Over the last two decades in particular, FDI has come to play a growing role in most developing countries' total investment. (Figure 3.) However, striking as the rise in the importance of FDI may seem in host countries' resource flows, FDI is only part of the total financing by foreign investors in host countries. At the same time that foreign companies mobilize resources within their own corporate systems, their affiliates can also raise funds through bonds, loans, and equity issuances. To the extent that these sources are in the international capital markets, they increase the total inflows of foreign financial resources for development. Indeed, as data for United States transnational corporations suggest, the flows of external resources to host countries due to the presence of foreign enterprises often double FDI flows alone.[3]

Figure 3: Ratio of FDI to Gross Fixed Capital Formation (%)



Source : World Bank, World Development Report, 2002.

12. Meanwhile, because transnational corporations typically have access to a wide variety of financing options, the risk-adjusted cost of capital is usually lower for them than the domestic firms from developing countries. This advantage enables them to be more responsive than other firms to investment opportunities and incentives.

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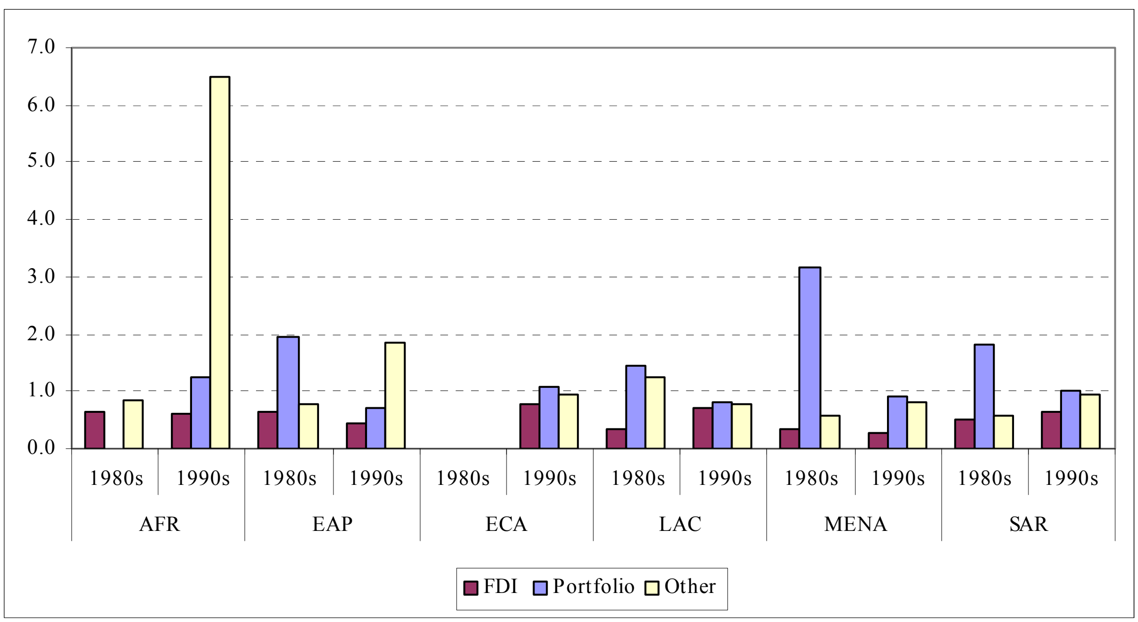
[3] UNCTAD, World Investment Report, 1999.

Consequently, they can undertake projects for which domestic investors do not have the capacities to assume or which are considered too risky for host country firms. As such, they enlarge the investment frontiers in host countries. With time, conditions conducive to domestic investors may be established in activities that are beyond their current reach. In such cases, FDI also serves to stimulate domestic investment, whereby boosts the total host country investment further. Empirical studies lend support to such "crowding in" effects of FDI. In Borensztein et al (1995), for example, it was estimated that the total increase in investment was between 1.5 and 2.3 times the increase in the flows of FDI.[4]

13. More importantly, FDI not only adds to external financial resources for host country development, it is also more stable than other forms of financing. Typically, FDI is based on a long-term view of the market, the growth potential and the structural characteristics of the recipient countries. It is thus less prone to reversals in adverse situations than bank lending or portfolio flows. This feature of FDI is clearly evident from Figure 4, which compares the coefficient of variations (the higher the value, the more volatile the resource flows) of FDI with that of portfolio investments and other forms of private financial flows (mainly debt) to developing countries between 1980-2000.

Figure 4: Volatility of Capital Flows in Developing Countries



Source: World Bank, Global Development Finance, 2002.

14. Clearly, FDI is a much more stable form of external financing than all other types of financial flows. Out of the 136 countries for which data are available, only 27 countries experienced more volatility in their FDI inflows than other forms of external

[4] Borensztein, E. and J. W. Lee (1995), "How does foreign direct investment affect economic growth?" NBER Working Paper No. 5057.

private financing during the 1980s, and this number was reduced to 22 in the more turbulent 1990s. More recent data further confirm the resilience of FDI flows: Brazil continues to absorb large volumes of FDI in the first half of this year – it is the number 2 recipient of FDI among all developing countries (after China) - despite the current downturn in that country.

15. Finally, even though FDI may have a debt-creating component, it is essentially equity investment.[5] Profits are repatriated only when a project yields return and part of the profits is routinely reinvested in the host country. As such, most of the risks are born by the shareholders of the foreign companies. This has marked advantage over bank lending, which must be repaid with fixed interest regardless of the performance of the project for which the loan was used. Moreover, creditors often look towards taxpayers to hold them harmless when projects fail. This is especially true in times of systemic financial crisis, when government bail-outs are routinely sought and obtained by the banks, adding to the tax burdens of host country taxpayers. Therefore, FDI will by definition not lead to a debt crisis and debt relief will never be an issue.

2. FDI and Productivity Growth

16. In traditional economic thinking, productivity growth measures the contribution of exogenous technological changes to economic growth. However, new understandings of the growth process, especially with the advent of the endogenous growth theory, call for caution in such an interpretation. Depending on the nature of the technology (labor or capital saving), the structure of the economy, and the ease of substitution between factors of production, technological change may be either more or less than TFP growth. At the same time, the importance of the "soft" side of technological advance – organizational structure, managerial practices, tacit knowledge, etc. – is increasingly recognized as an integral part of the whole technological upgrade process, contributing to the overall productivity growth.

17. Whatever its precise level of contribution to economic growth, the importance of technological and organizational advance has long been firmly established. In the long pre-Industrial Revolution period, a long term growth rate of 0.2 percent per year was considered remarkable. The technological breakthrough in late 18th century Britain doubled the growth potential, but it was still lackluster compared to the 8 percent annual growth seen in the high performing East Asian economies in recent decades. Just like the fast growth in postwar Europe, such rapid economic growth of the developing countries in the second half of the 20th century owed much to the reduction in barriers to the emulation of technical and organizational innovations from the world's leading countries. Indeed, rather than re-inventing what had already existed elsewhere, those developing countries that were able to import and imitate the best practice from more advanced economies enjoyed unprecedented economic growth. For developing world at large, the

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[5] The debt-creating component of FDI accounts for less than 18 percent of the inflows of FDI to developing countries between 1990-1998. UNCTAD, World Investment Report, 1999.

rapid and efficient transfer and adoption of "best practice" across borders becomes the very essence of economic development.

18. Best practice may be transmitted across borders by various mechanisms. Foreign buyers of exports may provide the demand for upgrading, as well as some level of technical assistance to domestic firms. Imported capital goods may embody improved technology. Technology licensing allows countries to acquire innovations. Expatriates transmit knowledge. Yet, arguably the most effective means of transferring best practice is FDI as foreign investment tends to package and integrate elements from all of the above mechanisms.[6] In fact, the most important benefit of FDI is that it provides, along with financial resources, access to the whole range of technological, organizational and skill assets, as well as the markets of the parent company. With few exceptions, the vast majority of the fast-growing economies relied heavily on FDI to jump start and sustain their rapid economic transformation.[7]

19. FDI transmits best practice in two ways: internal transfers of technology and skills to the foreign affiliates in the host country, and technological diffusion to a broad section of companies and institutions within the host country. Although the internal transfers of best practice benefit principally the affiliates, to the extent that foreign-owned firms outperform domestic counterparts, their presence still constitutes a valuable asset to the host country.[8] First of all, many of the technologies are based on expensive R&D integral to branded products that firms generally will not sell to unrelated parties. Direct investments are thus the only mechanism for the host country to obtain the latest technologies and expand its productive base. Secondly, because foreign affiliates are generally at the forefront to introduce new management and organizational techniques, quality control standards, and marketing methods, they tend to absorb best practice more quickly than local firms. Thanks to their lower learning failures, the affiliates may serve as a test ground of these new approaches in the host country. Finally, for many developing countries, being incorporated into a global company's international production network is the easiest way for them to gain access to regional or global markets.

20. Nevertheless, the ultimate impact of FDI on domestic economic growth depends on the diffusion of best practice through the local economy at large. This diffusion process takes place through four main channels: backward linkages with local suppliers (sourcing), forward linkages with local producers and distributors, horizontal linkages

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[6] Klein, M., C. Aaron, and B. Hadjimichael (2001), "Foreign direct investment and poverty reduction," Policy Research Working Paper No. 2613, The World Bank.

[7] Japan and Korea are essentially the only examples of countries which achieved rapid growth with minimal reliance on FDI. This strategy is very difficult to replicate, especially in countries without a solid skill base, a buoyant entrepreneurial spirit, a capable bureaucracy, and conducive incentive regimes.

[8] Many studies show that foreign ownership positively correlates with productivity increases of the firm. See Ramachandran, V. and M. K. Shah (1997), "The effects of foreign ownership in Africa: evidence from Ghana, Kenya and Zimbabwe," RPED Paper No. 81, The World Bank.; Djankov, S. and B. Hoekman (1998), "Foreign investment and productivity growth in Czech enterprises," Policy Research Working Paper 2115, The World Bank.; and Aitken, B. and A. E. Harrison (1999), Do domestic firms benefit from direct foreign investment? Evidence from Venezuela," *The American Economic Review*, Vol. 89, No. 3.

with local competitors, and linkages with local institutions such as universities and research institutes as well as vocational training centers. To developing countries, the most important channel of these is usually sourcing: the purchase of inputs and services from local instead of foreign suppliers.

21. All things (cost, quality, reliability, etc.) being equal, local procurement is generally preferred than arm's length suppliers or in-house production because proximity lowers transaction costs and allows for greater flexibility and specialization. This is why whenever the costs of doing so are lower than the resulting savings, foreign investors have an interest in developing local suppliers, helping them set up facilities, raise technological and skill levels, obtain inputs, and expand markets. To the host economy, this is often one of the most powerful mechanism for transmission of best practice. The strengthening of these suppliers can in turn lead to various further spillovers to the rest of the economy through demonstration effects, mobility of trained labor, enterprise spin-offs, and competition effects.

22. The extent to which foreign affiliates establish backward linkages with local suppliers varies from industry to industry and country to country. Although there is widespread concern in developing countries that foreign affiliates have too limited connection with the rest of the host economy, several empirical studies have demonstrated that in some industries (e.g. automobile) and in countries where adequate supplier capacities are present, foreign investors made extensive efforts to upgrade prospective suppliers and relied even more heavily on local suppliers than domestic firms.[9]

23. Ultimately, the diffusion of best practice in the host country depends on the way domestic markets work, as well as the absorptive capacities of domestic firms. Where the market incentive structures are severely distorted, FDI inflows will tend to be more exploitive and rent-seeking in nature, bringing limited benefits to the host country. Similarly, when the domestic knowledge base is thin and information is asymmetric, few diffusion channels will be established for transferring best practice.

B. A Mechanism for Social Advancement

24. At the same time that FDI serves as a catalyst for rapid economic growth by enabling developing countries to leapfrog developmental stages and to catch up with advanced economies, it constitutes also an important advocate for improved social norms. In this respect, FDI plays a major role in the larger development agenda of the host countries. Here, two of the main social aspects of development – employment and environment - are discussed in detail.

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[9] See examples in Lall, S. (1980), "Vertical interfirm linkages in LDCs: an empirical study," *Oxford Bulletin of Economics and Statistics*, Vol 42, No. 3. on India; UNCTAD (2000), *World Investment Report* on Argentina, Brazil and Thailand; Batra G. and H. Tan (2000), *Interfirm linkages and productivity growth: evidence form Malaysian manufacturing*, The World Bank; and Barnes, J. and R. Kaplinsky (2000), "Globalization and the death of local firms? Automobile component section in South Africa.

1. Employment and Labor Standard

25. Increasing gainful and secure employment has always ranked high as a policy objective for developing countries. It is a principal means to achieve an equitable distribution of income and higher standard of welfare for the majority of the population. Because of the special features of foreign investments – they tend to be larger in size, with greater technological sophistication, facing more competitive pressures in their product markets, and having more room of maneuver in their operations as compared to domestic enterprises – FDI often plays a unique role in employment creation and upgrading of the host countries.

26. There are three basic mechanisms for FDI to generate employment in the recipient countries. First, foreign affiliates employ people in their domestic operations. Second, through backward and forward linkages, employment is created in enterprises that are suppliers, subcontractors, or service providers to them. Third, as FDI-related industries expand and the local economy grows, employment is also created in sectors and activities that are not even indirectly linked to the original FDI.

27. Comprehensive data are absent with respect to the employment generated by FDI in developing countries. Estimates put the direct employment created by foreign affiliates at less than two percent of the labor force in most developing countries, although the share would be higher when only formal employment is considered and it is often substantial in the modern manufacturing sector.[10] In Thailand, for example, FDI accounts for about 17 percent of the total manufacturing employment in the late 1980s, as well as a growing share of new employment generation in the poorer provinces far away from Bangkok.[11] Indirect employment created by foreign affiliates, by contrast, can be large where the interaction between FDI and the local economy is intense. Based on a series of eight case studies in both developed and developing countries, one study estimated that when only the indirect employment generated by backward and forward linkages was considered, 1.6 jobs were created indirectly for each job created directly by a foreign affiliate.[12]

28. While the *quantity* of employment creation ranks high in the policy agenda of developing countries, the *quality* of the jobs created through FDI preoccupies the policy makers with equal weight. Despite the popular notion that foreign investors are attracted to developing countries principally, or even solely, by the low labor costs, realities point to the opposite. In fact, there is general agreement that multinational companies provide employment on conditions that, on the whole, compare favorably with the prevailing

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[10] UNCTAD, *World Investment Report*, 1994.
[11] Brimble, P. and J. Sherman (1998). "the Broader impacts of foreign direct investment on economic development in Thailand: corporate responses." Paper prepared for High Level Roundtable on FDI and its Impact on Poverty Alleviation, December 1998.
[12] Dupuy, C and J. Savary (1993). "Les effets indirects des entreprises multinationales sur l'emploi des pays d'accueil. » ILO Working Paper No. 72.

practices in host countries. In particular, well-established large multinational enterprises are most likely to comply with international labor standards and employ good labor practices. Indeed, because of their size, technological sophistication, the need to meet high product standards, and exposure to international scrutiny, foreign affiliates have come to be expected to offer higher remuneration, superior working conditions, and more skill upgrading opportunities to their workers than domestic firms.

29. In parallel to technological spillovers, best employment practices can be transferred to host countries when the foreign affiliates are well integrated into the local economy. In this respect, the cross-border diffusion of modern organizational and managerial techniques has the most impact on the working conditions and human resource development styles of the receiving countries. By creating a more efficient and more productive work pattern, FDI helps to set new employment norms and higher labor standards in the relevant industries and localities. In China, for example, it was through foreign investments that a new form of labor-contract system was first introduced in the early 1980s, which linked remuneration and bonuses to labor productivity. The new reward system was so successful that it eventually led to the country-wide wage and labor market reforms.

30. Finally, as part of the cross-border transfer of its human resource management practices, FDI also brings with it the kind of modern industrial relations that are prevalent in advanced countries.[13] In general, foreign investors adapt their industrial relations systems to the legislations and practices of their host countries. In doing so, their approach to management-labor relations is influenced by the attitudes of the host country governments. The global character of FDI, however, suggests that large foreign companies may pursue practices that differ in some respects from those of indigenous enterprises in a host country. Internationally, there is a broad trend towards increased communication between management and workers. As multinational corporations are typically firms that invest in their workforce and deal with workers' organizations with a view towards establishing an effective relationship, industrial relations difficulties do not arise more frequently in foreign affiliates than in domestic firms. Conversely, to the extent that their labor practices are more consultative in nature owing to their international experiences, their pattern of industrial relations often becomes a model for domestic firms and that part of the labor force that is not organized.

2. Environmental Standards

31. The environmental degradation in developing countries is the combined consequence of the production and consumption patterns both within the countries and in their export markets. In a globalized world economy, the impact of these forces are amplified, with FDI serving as another conduit. Nonetheless, while it is undeniable that there have been cases where powerful companies relocate polluting production to countries or regions out of considerations of weak environmental standards, there is no conclusive evidence that this is the rule. Overall, FDI flows to places where the net

[13] This is most relevant for investors from West European countries.

profitability is highest, not where costs are lowest. This is why not only most of the world's FDI flows to developed countries, where factor costs are higher and social standards more stringent, available data from the United States show that the share of pollution-intensive production is the highest in developed countries as well.[14] Therefore, there is no strong evidence to support the argument that FDI is putting pressure on developing countries to lower their environmental standards so as not to lose investment and jobs.

32. There have been several studies that attempt to test the "pollution haven" hypothesis. Both the correlation approach, which examines the relationship between outward FDI and environmental standards of host countries, and the location choice approach, which embeds environmental regulation as a determinants for FDI flows, fail to support this hypothesis.15 Only in selected case studies were examples found to sustain the notion that environmental standards were a factor in FDI location decisions. However, it should be pointed out that these case studies suffer from selection bias because only firms that have actually shifted location were documented.[16]

33. Essentially, environmental resources are an input into the production process. The impact of industrial activities on the environment is thus closely linked to the production efficiency of firms and their capacity to manage environmental risks. Environmental damage tends to be greatest in low productivity operations that employ obsolete technology, outdated work methods, poor human resource management techniques, and inefficient energy use. In this context, on account of its stronger technological and management base, FDI is actually better positioned to uphold higher environmental standards than their domestic counterparts. There is indeed some evidence to show that the majority of foreign companies rarely behave worse than is the general practice in the recipient county. Rather, they tend to espouse better environmental practices and contribute to an improvement of local environment.[17]

34. Therefore, instead of being feared as a cause for the "race to the bottom" in developing countries' effort to generate growth, FDI should be viewed as a force to bring about better environmental standards. Because of their connections to the developed world, where affluent and environmentally demanding markets call for stringent environmental regulations and environment-friendly products, FDI can become a conduit for transferring clean technology and sound environmental management systems.

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[14] UNCTAD, *World Investment Report*, 1999.

[15] See Adams J. (1997), "Environmental policy and competitiveness in a globalized economy: conceptual issues and a review of the empirical evidence", in OECD Globalization and Environment: Preliminary Perspectives; and Eskeland G. and A. Harrison (1997), "Moving to greener pastures? Multinational and the pollution haven hypothesis" The World Bank, mimeo.

[16] UNCTAD op. cit.

[17] See Pearson, C. (1987), *Multinational corporations, the environment and the third world*, North Carolina: Duke University Press; Leonard, D. (1998), *Pollution and the struggle for the world product*, Cambridge: Cambridge University Press; Gentry, B. (ed.), (1998), *Private capital flows and the environment: lessons from Latin America,* Cheltenham: Edward Elgar Publishing; and Wheeler , D. (2001), "Racing to the bottom? Foreign investment and air pollution in developing countries," mimeo, The World Bank.

C. Potential Negative Impacts of FDI

35. As reviewed in detail in the discussions above, FDI has a key role to play in host countries' economic development. This does not mean, however, that FDI can never lead to undesirable outcomes under all circumstances. Indeed, even with the best of intentions, FDI may sometimes produce objectionable results that are harmful to host developing countries. It is also undeniable that, rare though they are, some foreign investments may be exploitive in nature and need to be properly regulated. Some of the negative impacts of FDI are reviewed in the following section. As will be seen, in most cases, these negative effects are a reaction to the distortions and inefficiencies in the domestic markets. Therefore, they are essentially avoidable with appropriate policy tools and a sound regulatory framework.

1. The "Crowding Out" Effect of FDI

36. Notwithstanding the empirical evidence that FDI usually results in proportionally more investment than what can be counted for by FDI alone, there is the lingering concern that foreign investments may take away the investment opportunities of domestic firms, thereby driving them out of business. Such a situation may occur in either financial markets or product markets. If the foreign investor finances the project by borrowing from the host country financial market under conditions of scarce resources, domestic interest rates may rise as a result, which may make borrowing unaffordable for some domestic firms. Precisely to prevent this from happening, Chile, a country with generally liberal policies towards FDI, has retained the right to limit the access of foreign companies to domestic banking system. Even though the provision has never been invoked, its very existence testifies to the unease among small developing countries over such potential problems.[18]

37. If FDI enters the economy in activities in which competing domestic firms already exist, FDI may well reduce domestic investments that would have been undertaken by domestic producers. Even in new activities beyond the current reach of domestic investors, FDI may preempt investments by domestic firms which, with proper nurturing, could enter the market successfully. The problem becomes all the more grave if the foreign investment deliberately uses predatory practices to force competitors out of business, or to retard their establishment. Especially in places where the host governments lack efficient competition policy tools and skills to keep such behavior in check, a strong FDI presence may inhibit the development of local capacities. In most cases, crowding out by FDI does not necessarily mean an absolute reduction in total investment, but rather that the increase is not proportionate to FDI inflows.

38. Real world evidence suggests that while crowding in or neutral effects of FDI prevails, crowding out is not uncommon either. Much depends on the domestic market

[18] UNCTAD op. cit.

situation. In an econometric exercise carried out to investigate this issue, it was found that neutral effects dominated in half of the countries, while crowding in and crowding out occurred with equal frequency, taking place in 25 percent of the countries each.[19] A general conclusion is that whereas the existence of crowding out cannot be ruled out, it does not appear to be the general case. Equally inconclusive are the policy actions to mend the problem. In Korea, for example, the policy to restrict foreign investments in certain industries indeed led to the emergence of successful domestic producers. In Brazil, however, the same policy intervention in the 1980s proved to be not only costly but with uncertain results. The message is thus that instead of trying to avoid the problem through "restriction", i.e. prohibiting FDI from entering certain sectors, efforts should concentrate on enforcing appropriate competition policies and the related regulations so as to prevent abusive practices in the domestic markets.

2. The Balance of Payment Problem as a Result of FDI

39. Another wide-spread concern regarding FDI is that to the extent that profits are repatriated, they constitute a financial outflow that has to be set against the net annual contribution of FDI inflows to a host country's balance of payment. This issue was of considerable interest in the early 1970s, when a majority of developing countries faced stringent foreign exchange constraints. With increased current and capital accounts liberalizaton in many developing countries, this is less of a concern. However, as there are still a number of countries with various degrees of foreign exchange controls, the balance of payment issue remains relevant.

40. Nevertheless, the gravity of the problem appears to be restrained. Comparisons of repatriated earnings and FDI inflows during the 1990s show that even in Africa, where the repatriation ratio was the highest (an annual average of 75 percent), there was never a negative external balance as a result of FDI. Moreover, several indirect effects need to be taken into consideration when assessing the balance of payment impacts of FDI. As is often the case, FDI in trade activities generates foreign exchanges through exports, which counter the financial outflows of repatriated profits. Even with projects in non-tradable activities, FDI can enhance the competitiveness of tradable activities, thus contributing to the overall export performance of the host country. Therefore, in the long run, FDI should not be a cause for the balance of payment problem, except in countries with seriously misaligned foreign exchange regimes. In this case, the real solution is not restricting FDI, but rather addressing the foreign exchange constraints of the economies.

3. Enclave Economies Created by FDI

41. The most voiced concern with regard to FDI is undoubtedly that such investments are narrowly based, with limited overall impact on the receiving countries, and benefiting only a small group of the population. Such anxieties are most exemplified by the mining and other raw material extraction projects, which are typically very capital intensive and

[19] Op cit.

employ a small fraction of the national workforce. This means that few linkages, either backward or forward, exist with the host economies, making their indirect effects on the domestic economy negligible. To make things worse, sudden large inflows of foreign exchange tend to raise the real exchange rate of the host economy and thus render many non-extraction activities unprofitable (the Dutch Disease). Moreover, such projects often display low revenue retention for host countries because a large fraction of export earnings flow immediately overseas to service the foreign capital investment.[20]

42. Another example of the enclave economies is the Export Processing Zones (EPZs), which have become a popular strategy in developing countries to foster exports and to promote employment. With the wide range of exemptions and special privileges granted to investments located in the EPZs, they too exhibit very limited linkage with the local economies at large. In particular, low labor costs and avoidance of normal rules and regulations are often the main advantages sought by the FDI in such locations, who also tend to be footloose and have little incentive to transfer skills or technologies. Consequently, even though the immediate export and employment benefits are undeniable, the long-term sustainability and economic impacts of these zones are less certain.

43. However, despite the natural tendency of mining projects and EPZs towards enclave economies, this does not have to be the case and it is not reason enough for developing country governments to shun from the foreign investments into these activities. What they need to do is to create the right incentives and proper environment for such investors to enlarge the scope of their activities. In the mining and natural resource projects, for example, there have been successful examples of countries which managed to use prudent macroeconomic policies to guard against excessive exchange rate appreciation and sound regulations to minimize the opportunities of insiders for corruption and to use the windfall gains for poverty alleviation.[21] In many developing countries, some of the EPZs are turning into "smart" zones with a number of strategies to ensure broader technology and skills transfer both within and outside the zones.

III. The Determinants of FDI Location

44. With the rising importance of FDI in world economy, numerous attempts have been made to isolate the factors that explain its size and location. As remarked by Agarwal (1980), "The growth of foreign direct investment has been excelled by the growth of publications specially on the determinants of these investments."[22] From every angle and for both developed and developing countries, researchers have examined

[20] See Auty, R. M. (1993), *Sustaining development in mineral economies: the resource curse thesis*, London: Routledge; and Sachs, J. and A. M. Warner (1995). "Natural resource abundance and economic growth." NBER Working Paper 5398.
[21] Such examples include Botswana, Chile, Indonesia, Malaysia, Mauritius, Mexico and Oman.
[22] Agarwal, J.P. (1980). "Determinants of foreign direct investment: a survey," *Weltwirtschaftliches Archive*, Vol. 116.

political, economic, social, and policy variables in their search for "the most important" determinants of FDI flows. The discussion below synthesizes the results of this vast literature and summarizes the basic elements of attractiveness that draw foreign investors to a country.

45. *Market demand*. The flows of FDI is positively influenced by the size of a country's market demand as measured by GDP per capita. This confirms the casual observation that most FDI flows to affluent OECD countries and it is particularly true with market-seeking type of FDI. Even in developing countries, where FDI inflows tend to be more input-seeking, a country's overall development level still has a strong bearing on how much FDI it attracts.

46. *Growth rate*. FDI flows to where fast economic growth has been recorded. A virtuous circle is observed here: at same time that FDI contributes significantly to economic growth, faster economic growth attracts more FDI because it increases foreign investors' confidence in the economy, which in turn pushes the growth rate even higher. In the least developed countries, studies have shown that FDI in fact follows, not proceeds, some initial growth or at least the promise of growth.

47. *Political stability*. Quite understandably, incidences of political coups, assassinations, riots, or armed conflicts may exert a dominant negative influence on foreign companies' investment decisions. Indeed, frequent changes of governments and the resultant policy changes can reduce an investor's assets to zero overnight. In the absence of significant reserves of nonrenewable natural resources (e.g. oil), rarely would any foreign investors accept serious political risks or frequent policy reversals.

48. *Macroeconomic stability*. A country's overall macroeconomic performance, such as low inflation rate and balanced fiscal account, is a consistently significant factor in shaping the decision making of foreign investors when assessing investment locations. Because macroeconomic instability makes it difficult for investors to evaluate the true costs and returns of their investments, only in rare cases would FDI flows to places where there is hyperinflation or severe imbalances in their internal and external positions.

49. *Infrastructure*. With regards to FDI, infrastructure encompasses both physical (e.g. roads and power) and social (e.g. health and education) concepts. It has been repeatedly shown around the world that a well-developed infrastructure network and a well-trained labor force are major elements of attractiveness to foreign investors. This is especially true where high quality FDI (e.g. long-term transfer of advanced technology) is concerned.

50. *Regulatory environment*. It is increasingly recognized that the administrative and regulatory environment of a country can have a significant influence on the level of FDI flows. While large and powerful investors may be able to endure cumbersome and costly procedures, they may prove fatal to the entry and growth of small and medium enterprises. Moreover, arbitrary, discriminatory, and non-transparent regulations often lead to corruption, which has been shown to be a fatal deterrent to FDI.

51. *Investment promotion*. Once a country has established a reasonably appealing investment climate, how much FDI it gets depends also on its marketing efforts to attract foreign investment. Granted, no amount of promotion can substitute for a truly investment-friendly environment, but when other factors are similar – as it true in economies having attained a certain level of development – promotion efforts do make a difference.

52. In this context, mention should be made to the fiscal incentive schemes that host governments often feel obliged to offer in order to attract FDI. There have indeed be examples of such "tax heavens" which are highly successful with mobile multinational companies. Most economic studies and surveys of international investors, however, have repeatedly shown that these incentives are not nearly as influential in the location decisions of foreign investors as it is usually believed. That is, even though all investors would seek the lowest tax liabilities when it is possible – just like they would prefer low factor costs when all other conditions are equal - the various factors discussed above are far more important in their site selections than special fiscal incentives. Whether investment incentives are needed for a country to attract FDI and what types of incentives to use depend largely on the nature of the prospective investors' activities, their motivation for investing abroad, with whom the hosting country is competing for these investors, and if the country has the fiscal capacity to swallow the revenue losses and the administrative capacity to manage its chosen incentive regimes. Overall, global companies give more importance to the simplicity and stability of a country's tax system than generous tax rebates.

IV. What Do the States Need To Do?

53. The previous discussions highlight the role of FDI in economic development – while not a panacea, it is a critical ingredient to the long term sustainable growth. For developing countries, it presents the most effective way to enhance productivity and to develop an internationally competitive private sector; it creates employment and income opportunities; and it provides an important vehicle to raise environmental and social standards. Many developing countries have reaped these benefits. But neither FDI nor all its benefits flow automatically. Foreign investors are fallible people whose first and foremost objective for investing anywhere is to maximize their global profits, with or without benefits to host countries. Recognizing this simple business principle, it is possible to bring out the good sides of FDI and avoid its negative aspects.

54. Moreover, despite the tremendous potential of FDI in economic development, it does not provide answers to all developmental problems. For example, while FDI helps raising income levels, it cannot automatically reduce existing inequalities and can even exaggerate them in the short run by putting a premium on people with higher skills. Public policies need to be in place to support the poorer segments of society. The role of FDI in this process is, by virtue of its impact on productivity and growth, to generate the

resources needed to fund the government-led programs that improve social safety nets and provide basic social services. Moreover, the delivery of social services to the poor – from insurance schemes to access to basic services such as water and energy – can also benefit from reliance on foreign investors. It is thus imperative for the national governments to create the pre-conditions for FDI to flow in and work its wonders.

55. The most fundamental pre- requisites for FDI are enumerated in the previous section. The governments need thus to provide (i) basic political and macroeconomic stability that offers reasonable predictability so that investors can make normal business decisions; (ii) a rules-based legal and regulatory environment that facilitates doing business rather than harassing it; (iii) an adequate physical and social infrastructure that assist the smooth functioning of the market and transferring of knowledge; and (iv) appropriate investment promotion efforts that disseminate information about the investment site and service existing and potential investors.

56. Beyond these basic conditions, the governments will also need to address several specific issues in order to ensure the realization of the benefits of FDI. They include:[23]

57. *An even and competitive playing field***.** The benefits of FDI tend to be maximized when foreign investors operate on an even and competitive playing field. To this end, governments need to provide a business environment where competition, free entry, consumer choice and free exit determine who gains and who loses. Foreign and domestic investors need to be treated equally as much as possible.[24] As amply demonstrated in economic literature, exposure to effective competition on an even playing field is the most important incentive for foreign and domestic companies to upgrade technology and management practices, while free entry is the key to establishing effective linkages between foreign investors and domestic suppliers and distributors that help diffuse best practice in the host economy.[25]

58. *Domestic capacity to exploit FDI benefits***.** A liberal and competitive investment climate creates the basis for FDI to enter and raise the potential for productivity growth in the host economy, but improvements will only occur if the domestic actors are capable of responding to the new incentives. As discussed in the previous sections, the most serious deterrent to wider diffusion of best practice is a lack of indigenous capabilities to take advantage of the opportunities. The key policy measures are thus to improve the education and infrastructure so as to increase the domestic absorptive capacity of the fruits of FDI.

59. *Building up environmental and social standards***.** As globalization gradually leads to higher environmental and social standards of FDI, governments need to adjust their

[23] This discussion draws from Klein et al. (2001).
[24] It is recognized that given the special features of FDI as compared to domestic investments, differences in treatment are not entirely avoidable. But they need to be kept to a minimum.
[25] The negative impacts of FDI are most often linked to uncompetitive practices in the domestic markets and selective protections granted to certain firms. See Lall, S. and P. Streeten (1977), *Foreign investment, transnationals and developing countries*, Westview Press; and Graham, E. H. (1995). "Foreign direct investment in the world economy." IMF Working Paper WP/95/59.

own policies to fit into the evolving world norm. In places where there remains a wide gap between the world standards and those of a host country, reputable foreign investors may be forced to stay away out of reputational concerns or they may face too much competition from domestic firms not subject to as stringent norms. To be sure, tougher standards have costs, which may affect both domestic firms and certain low-cost-seeking FDI. Governments have to decide how to position themselves for the long term benefits of their economic development.

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