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The Role of Host Country Private Sector Enterprises in the Realization of Positive Externalities from FDI-Inflows

Markus Taube

It seems to be an established fact that – especially for poor developing economies – it is even more difficult to realize positive externalities, i.e. social benefits, from FDI-inflows than to attract them in the first place. FDI may promote economic development of their host economies by means of an enlargement of the capital stock, by introducing new technologies and augmenting the human capital stock, by providing access to foreign markets, by opening new product markets in the host economies, etc. The most important channels for technology spillover from FDI to the domestic economies are usually seen to be (a) vertical linkages, where local enterprises up- and downstream the value chain may absorb technology and know-how introduced by a foreign invested enterprise (FIE); (b) horizontal linkages, where competitive pressure may induce local enterprises to imitate practices demonstrated by FIE; (c) a general upgrading of skills caused by FIE training-programs for workers and management personnel which over time might change back to domestic enterprises.

In order to realize any positive externalities through these transmission channels, however, a wide range of additional prerequisites has to be in place – the existence of a strong private sector being one of the most important. Out of the long list of parameters influencing the realization of social benefits from FDI-inflows in host economies this short note will therefore restrict itself to highlighting some features concerning the relevance of a strong private sector in the host economy.

Eliminating domestic market defects and preventing FIE from exploiting these

In today's world, wherever there are strong state-owned enterprise sectors, there are usually highly differentiated and complex protectionist arrangements in place. These protectionist arrangements are usually designed in order to protect the ability of state owned enterprises to fulfill certain semi-public functions in "inhospitable" economic environments, i.e. economic environments characterized by increasing market competition. However, the distortions of the "level-playing-field" brought about by these arrangements become highly counter-productive once they are hijacked by foreign investors.

When entering a host economy FIE are in general less motivated to initiate or promote multi-polar competition, but are rather interested in sharing in the monopoly rents made available in the economic system. In collusion with their (state-owned) Joint Venture partners or as 100% foreign capitalized subsidiaries they will try to make use of existing protectionist walls against other domestic or foreign competi-

tors, profit from subsidies and distorted price structures, etc. Eventually this may result in situations, where individual FIE are (involuntarily) invested with quasi-monopolies and market shares that allow them to dominate an industry long after the dissolution of the original protectionist measures.

In order to prevent FIE from behaving in such a "perverted" fashion and force them to act in way that promotes competition and market development, it is necessary to eliminate domestic market deficiencies and establish a working market system with competitive private actors and supply/demand based scarcity prices. Eventually this implies nothing less than a full-fledged privatization of the state-owned enterprise sector[1] and the evolution of a multi-polar market structure, where individual actors have an eye on their competitors and are powerful enough to prevent government agencies from implementing unfair and discriminating policies. Only then will it be possible to realize the full potential of growth impulses originating from FIE.

Forcing domestic enterprises to absorb technologies introduced by FIE

FIE are usually carriers of new technologies (understood as any kind of superior knowledge about production and organizational techniques), that are more or less appropriable by host country enterprises. This supply of innovative technologies, however, does not always meet a corresponding demand. Especially in the case of domestic state-owned enterprise managers who are still used to planned economy structures with guaranteed supply and sales "markets", soft budget constraints and perverted incentive structures, the motivation to appropriate new technologies and change existing operations can be expected to be limited.

Domestic enterprises therefore must have an incentive to actually absorb new technologies introduced by FIE. And there is no better means to force domestic enterprises to improve their operations but the creation and protection of highly competitive markets populated with private enterprises with hard budget constraint and a real bankruptcy threat. In highly competitive markets domestic enterprises have no leeway to ignore appropriable foreign technology, as this would result in a loss of relative competitiveness, market share and eventually profits. A higher intensity of competition will therefore induce a higher "demand" for foreign technologies.

This need for a competitive environment becomes even more pronounced when the costs of the appropriation of foreign technologies are taken into account. In many cases host economy enterprises will have to invest in reverse engineering efforts, licensing and / or management fees, the training of personnel etc. All this turns the appropriation of foreign technologies ("spillovers") into an entrepreneurial effort, which is neither cost- nor risk-free. Only private sector competition will provide the microeconomic incentives to attain in macroeconomic terms the optimal level of foreign technology appropriation.

[1] It is not sufficient to try to force State-owned-enterprises by means of management contract systems etc. to behave like private enterprises. Due to complex principal agent structures and insurmountable asymmetric information problems such experiments have never worked out as designed. See e.g.: Xu, Lixin Colin; Shirley, Mary M. (1998): Information, Incentives, and Commitment: An Empirical Analysis of Contracts Between Government and State Enterprises, in: The Journal of Law, Economics & Organization, Vol. 14, No. 2, 358-378.

Creating a level-playing field for domestic and foreign private entrepreneurs

The PR China is usually brought up as an example of an extremely successful approach to leverage FDI for host country economic development. This evaluation is certainly justified with respect to a wide range of issues. But the Chinese FDI story does also feature some dark sides. The greatest deficits might be diagnosed with regard to the relationship between FDI and the domestic (private) enterprise sector.

Not only has private sector initiative not been sufficiently tapped in order to spread FDI-induced growth impulses over the economy, but private entrepreneurs have been systematically discriminated against (e.g. with respect to the availability and price of bank loans, access to international markets, provision of legal security, etc.) which has resulted in a substitution of domestic entrepreneurship by FIE. There are some regions and industry branches where China has attracted *more FDI than necessary* and is therefore foregoing economic rents, which could have flown to domestic actors instead. A substantial share of the economic activities conducted by and rents accruing to Southern China's export-processing low-tech FIE, for example, might as well have been generated by domestic enterprises.

By discriminating against the private sector and discouraging the foundation and expansion of private enterprises, the Chinese government has been distorting the incentive structures potential domestic entrepreneurs are facing. Under the given conditions a large number of potential entrepreneurs has rather opted for working in a foreign funded enterprise where it was still possible to earn above-average salaries – with no entrepreneurial risks, than to take the risk of becoming a politically ostracized private entrepreneur.

In general it can be stated that FIE exert a strong attraction on the entrepreneurial and professional elite of their host economies. FIE are prestigious employers, offer above-average salaries, provide modern on-the-job-training and the possibility to substantially upgrade an employee's human-capital, i.e. market-value. If in the face of these pull-factors potential private entrepreneurs are also pushed into dependent employment as private sector initiatives are discriminated against, the economy as a whole runs into the danger of wasting its entrepreneurial potential and obstructing the evolution of a strong domestic private enterprise sector.

Implications

Recent experience tells us that the existence of a strong private sector is the main precondition host economies have to meet in order to reap the potential benefits going along with FDI inflows. Competitive markets and a strong private enterprise sector do not only "discipline" FIE. Crowding-in effects resulting from forward and backward linkages of FDI rely on competitive local firms featuring an entrepreneurial leadership. And it has been the private enterprise sector that has proven to be much more responsive to FIE activities than the state owned enterprise sector. It is private enterprises that have been the main transmitters of growth impulses and technology from FIE to the domestic industry.

The promotion of private entrepreneurs by means of free access to domestic and international goods and factor markets, an uncomplicated and transparent admini-

stration, non-discriminatory taxation policies etc. is therefore not only expected to improve a region's capability to make the best use of the business potential arising from FDI inflows. In addition the existence of a strong sector of highly entrepreneurial small and medium sized enterprises will attract FIE that are looking for a vivid local industry, ready to complement their own business activities.

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