



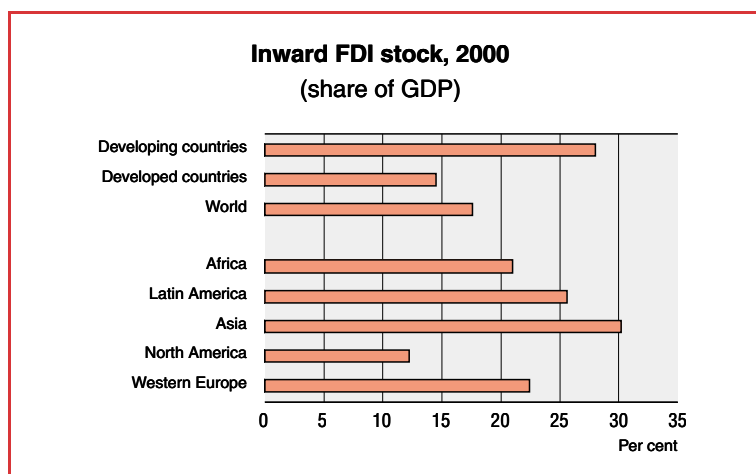
Foreign Direct Investment for Development

Maximising Benefits, Minimising Costs

Introduction

Developing countries, emerging economies and countries in transition increasingly see foreign direct investment (FDI) as a source of economic development and modernisation, income growth and employment. Countries have liberalised their FDI regimes and pursued other policies to attract investment. They have addressed the issue of how best to pursue domestic policies to maximise the benefits of foreign presence in the domestic economy. The report Foreign Direct Investment for Development by the OECD Committee on International Investment and Multi-national Enterprises attempts to shed light on these issues. The report focuses on the overall effect of FDI on macroeconomic growth and other welfare-enhancing processes, and on the channels through which these benefits take effect.

One commonly heard objection against the importance of FDI for development is that developing countries receive only a puny share of global FDI flows. However, while it is true that OECD economies alone account for between 80 and 90 per cent of world totals, the more appropriate measure of development impact is foreign corporate presence relative to the share of the domestic economy. Measured thus, FDI is far more important in many developing economies than, for instance, in North America (Figure 1).



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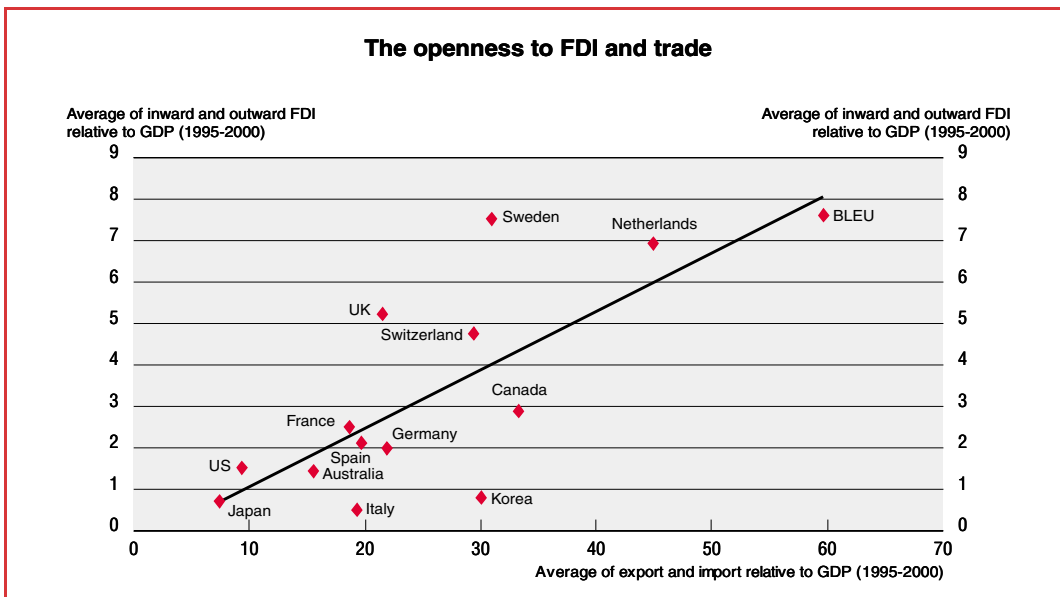
The overall benefits of FDI for developing country economies are well documented. Given the appropriate host-country policies and a basic level of development, a preponderance of studies shows that FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development. All of these contribute to higher economic growth, which is the most potent tool for alleviating poverty in developing countries. Moreover, beyond the strictly economic benefits, FDI may help improve environmental and social conditions in the host country by, for example, transferring “cleaner” technologies and leading to more socially responsible corporate policies.

While FDI on the whole is greatly beneficial to the development process, it must be recognised that certain drawbacks (“costs”) may occur. These drawbacks arguably reflect shortcomings in the domestic policies of host countries, but important challenges may nevertheless arise when these shortcomings cannot easily be addressed. Potential drawbacks include a deterioration of the balance of payments as profits are repatriated (albeit often offset by incoming FDI), social disruptions as a consequence of accelerated commercialisation in less developed countries, and the effects on competition in national markets. Moreover, some host country authorities perceive an increasing dependence on internationally operating enterprises as representing a loss of political sovereignty. ■

FDI and trade integration

As countries develop and approach industrialised-nation status, inward FDI contributes to their further integration into the global economy by engendering foreign trade flows (the link between openness to trade and investment is illustrated by Figure 2). Apparently, several factors are at play. They include the development of international networks of related enterprises and an increasing importance of foreign subsidiaries in MNEs’ strategies for distribution, sales and marketing. In both cases, this leads to an important policy conclusion, namely that a developing country’s ability to attract FDI depends on the entrant’s subsequent access to importing and exporting. This, in turn, implies that countries looking to attract investors should consider a policy of openness to international trade (for instance through participation in regional free trade zones) as central in their strategies. It also means that, by restricting imports from developing countries, wealthy nations effectively curtail these countries’ ability to attract FDI.

Some countries have attempted to use FDI in a more targeted manner to either boost exports or curb imports. As for the first of these points, FDI may clearly boost exports. For instance, inward investment can help host countries that had been financially constrained make use of their resource endowment (e.g. foreign investment in mineral extraction) or their geographical location (e.g. investment in some transition economies). However, the experience with targeted strategies has been mixed – particularly as regards



the so-called export-processing zones. Such zones tend to raise imports as well as exports, and it is not clear whether the benefits to the domestic economy justify the drawbacks that inevitably occur. The latter include the direct cost to the public purse and the risk of creating an uneven playing field between domestic and foreign enterprises.

Policies aimed at using inward investment to bring MNEs “inside the garden gate” and hence substitute for imports have also produced limited results. According to recent studies, FDI actually tends to lead to an upsurge in imports, which is gradually reduced as local companies acquire the skills to serve as subcontractors to the entrant MNEs. ■

FDI and technology transfers

Through FDI new technologies are brought into developing countries; these technologies are eventually diffused to the broader domestic business sector. The channels through which this may take place are legion, but researchers generally conclude that the most important source of technology spillovers are “vertical linkages” between MNEs and local suppliers. Foreign-owned enterprises usually provide their suppliers with technical assistance, training and other information to raise the quality of their products. Also, many MNEs assist local suppliers in purchasing raw materials and intermediate goods and in modernising or upgrading production facilities.

However, there appear to be great differences between the actual use that host countries are able to make of the technologies thus transferred. Crucially, the technologies need to be relevant to the host-country business sector and not just to the company that receives them first. In this respect, the general technological level of the host country’s business sector is of great importance. Evidence suggests that for FDI to have a more positive impact on productivity than domestic investment, the “technology gap” between domestic enterprises and foreign investors must be relatively limited. Where important differences prevail, or where the absolute technological level in the host country is low, local enterprises are unlikely to be able to absorb foreign technologies transferred via MNEs. ■

FDI and human capital enhancement

Investment in general education is of the utmost importance in creating an environment in which foreign enterprises wish to invest. Achieving a certain minimum level is paramount to a country’s ability not

only to attract FDI, but also to maximise the human capital spillovers that may arise from foreign enterprise presence. As is the case with technology, when a significant “knowledge gap” is allowed to persist between foreign entry and the rest of the host economy, no significant spillovers are likely.

The direct impact on human capital from FDI derives mainly from the fact that MNEs tend to provide more training and other upgrading of human capital than do domestic enterprises. However, evidence that the human capital thus created spills over to the rest of the host economy is much weaker. Moreover, it should be kept in mind that the magnitude of MNE-sponsored training is necessarily smaller than that of general (public) education. The beneficial effects of training provided by FDI can supplement, but not replace, a generic increase in skill levels. The presence of MNEs may, however, provide a useful demonstration effect, as the demand for skilled labour by these enterprises provides host-country authorities with an early indication of what skills are in demand.

Human capital levels and spillovers are closely interrelated with technology transfers. Technologically advanced sectors and host countries are more likely to see human capital spillovers and, conversely, economies with a high human capital component lend themselves more easily to technology spillovers. Consequently, efforts to reap the benefits of technology and human capital spillovers could gain effectiveness when policies of technological and educational improvement are undertaken conjointly. ■

FDI and competition

Since the early 1990s, a wave of mergers and acquisitions (M&As) has reshaped the global corporate landscape. At the same time, a surge in the number of strategic alliances has changed the way in which formally independent corporate entities interact. There has also been a wave of privatisations that have attracted considerable foreign direct investment (mainly in developing and emerging countries). This adds up to an increasing degree of concentration in national markets, which could have important effects on competition. Furthermore, empirical studies suggest that the effect of FDI on host-country concentration is, if anything, stronger in developing countries than in more mature economies.

On the other hand, foreign entry also has the potential to increase competitive pressures in a previously “cosy” national market. This argument is underpinned by the fact that MNE entry is generally found

to raise productivity levels among host-country incumbents (albeit more consistently so in developed than in developing countries). Unsurprisingly, this effect is strongest in markets where there appears to have been little competition prior to the foreign entry.

Foreign market entry may lead to increasing competition, which may lead to the closure of weaker enterprises, which may lead to increasing market concentration, which may lead to decreasing competition. Hence, while it is desirable that strongly performing entrants be allowed to replace less productive domestic enterprises, policies to safeguard a healthy degree of competition must be in place. The best way of achieving this is by expanding the "relevant market" by increasing the host economy's openness to international trade. In addition, efficiency-enhancing national competition laws and enforcement agencies are needed to minimise the anti-competitive effects of weaker firms exiting the market. ■

FDI and enterprise development

Foreign-orchestrated takeovers lead to changes in management and corporate governance. MNEs mostly impose their own company policies, internal reporting systems and principles of information disclosure on acquired enterprises (although cases of learning from subsidiaries have also been seen), and a number of foreign managers normally come with the takeover. Where foreign corporate practices are superior to the ones prevailing in the host economy this boosts corporate efficiency. However, in some cases country-specific competences are an asset for managers in subsidiaries. Therefore MNEs usually need to strive toward an optimal mix of local and foreign management.

Foreign participation in the privatisation of government-owned enterprises is a case in point. Experiences, many of them from the transition economies in East and Central Europe, have been largely positive. Researchers have found that participation by MNEs in privatisations has consistently improved the efficiency of the acquired enterprises. Some political controversies have, however, occurred because the efficiency gains were often associated with sizeable job losses (in the short run, at least). Moreover, it has been argued by some that the good experiences with MNE participation in the privatisation process of transition economies could simply reflect the fact that few domestic strategic investors have access to sufficient finance. In those (few) cases where domestic private

investors were brought into previously publicly owned enterprises important efficiency gains also occurred.

The privatisation of utilities is often particularly sensitive, as these enterprises often enjoy monopolistic market power within segments of the local economy. The first-best privatisation strategy recommended by the OECD is to link privatisation with an opening of markets to greater competition. But where the privatised entity remains largely unreconstructed prior to privatisation, local authorities often resort to attracting foreign investors by promising them protection from competition for a designated period. In this case there is a heightened need for strong, independent domestic regulatory oversight. ■

FDI and environmental and social issues

FDI affects not only the economy of the host country. Foreign corporate presence does in many cases also have important effects on social conditions and the environment, and most studies conclude that FDI has the potential to greatly benefit the environment in developing countries. However, for this potential to turn into tangible benefits, host country authorities need to pursue adequate environmental policies. For instance, to reap the full environmental benefits of inward FDI, adequate local capacities are needed, as regards environmental practices and the broader technological capabilities of host-country enterprises.

The technologies that are transferred to developing countries in connection with FDI tend to be more modern and environmentally "cleaner" than what is locally available. Moreover, positive spillovers have been observed where local imitation, employment turnover and supply-chain requirements led to more general environmental improvements in the host economy. There has been anecdotal evidence of MNEs moving equipment deemed environmentally unsuitable in the home country to their affiliates in developing countries, but this does not seem to represent a more general trend.

Empirical studies have found little support for the assertion that policymakers' efforts to attract FDI may lead to "pollution havens" or a "race to the bottom". Apparently, the cost of environmental compliance is so limited (and the cost to a firm's reputation of being seen as trying to avoid compliance so great) that most MNEs allocate production to developing countries regardless of these countries' environmental regulations. The evidence supporting this argument seems to depend on the wealth and the degree of environ-

mental concern in the MNEs' other countries of operation.

The linkage between FDI and social conditions is not very well documented by empirical research. However, such evidence as there is indicates that foreign investment may help reduce poverty (see also Figure 3). The general effects of FDI on growth are essential: Higher incomes in developing countries generally benefit the poorest segments of the population proportionately. The beneficial effects of FDI on poverty reduction are potentially stronger when FDI is employed as a tool to develop labour-intensive industries – and where it is anchored in the adherence of MNEs to national labour law and internationally accepted labour standards.

There is little evidence that foreign corporate presence in developing countries leads to a general deterioration of basic social values, such as core labour standards. On the contrary, empirical studies have found a positive relationship between FDI and workers' rights. Low labour standards may, in some cases, even act as a deterrent to FDI, due to investors' concerns about their reputation elsewhere in the world and their fears of social unrest in the host country. ■

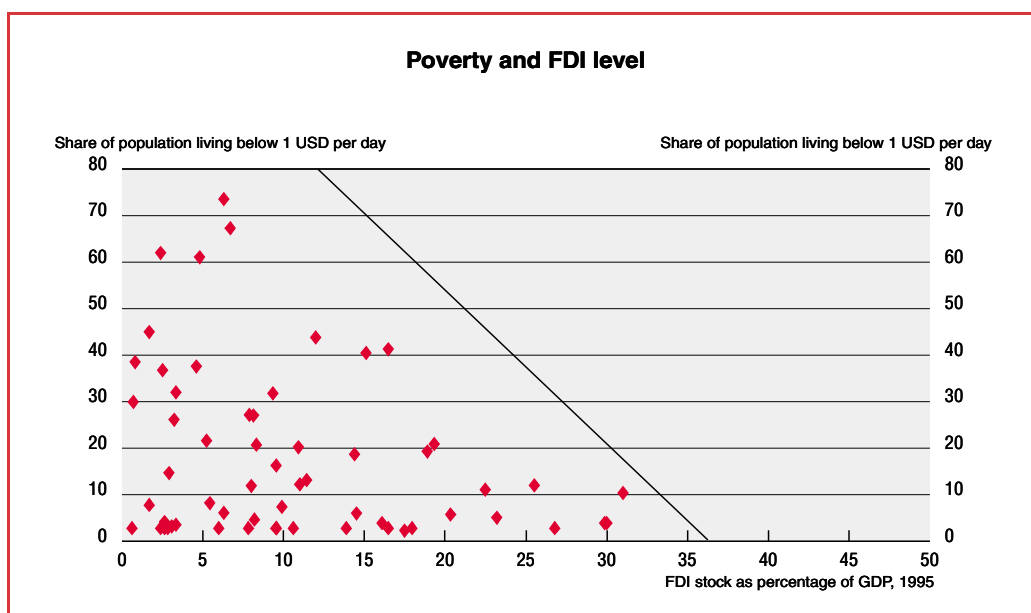
What should host countries do?

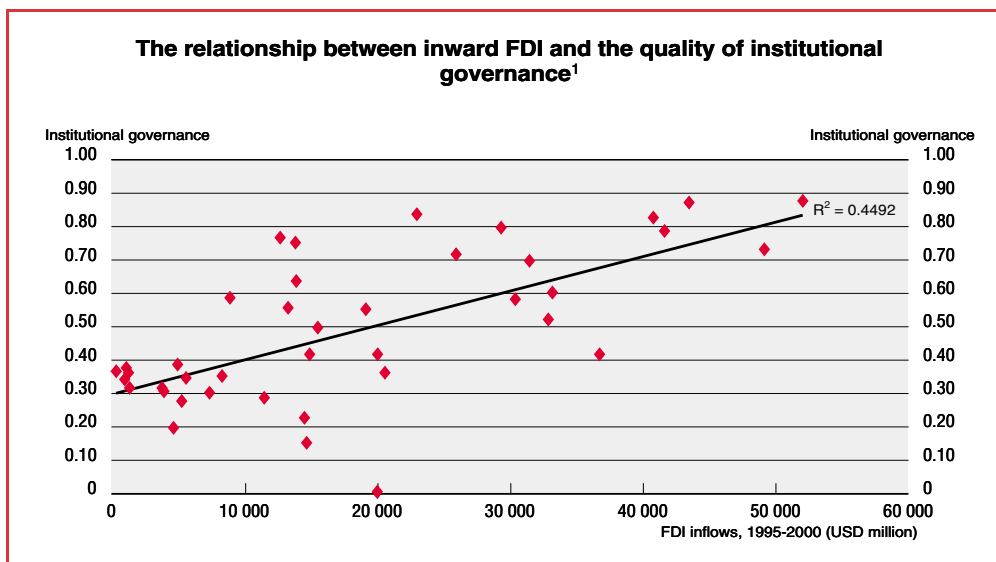
Sound host-country policies toward attracting FDI and benefiting from foreign corporate presence are largely equivalent to policies for mobilising domestic resources for productive investment. A benign

domestic business environment is vital not only to mobilise domestic resources but to attract and effectively use international investment. The experience of OECD Members and other countries shows that the measures available to host-country authorities fall into three categories. First, there is a need to improve general macroeconomic and institutional frameworks. Second, the creation of a regulatory environment that is conducive to inward FDI is very important. Third, infrastructure, technology and human competences should be upgraded to a level where the full potential benefits of foreign corporate presence can be realised.

The first of these points establishes the fact that every aspect of host countries' economic and governance practices affects the investment climate. The overall goal for policymakers must, therefore, be to strive for the greatest possible macroeconomic stability and institutional predictability. More concretely, the following recommendations are widely supported:

- Pursue sound macroeconomic policies geared to sustained high economic growth and employment, price stability and sustainable external accounts.
- Promote medium-term fiscal discipline, efficient and socially just tax systems, and prudent public-sector debt management.
- Strengthen domestic financial systems, in order to make domestic financial resources available to supplement and complement foreign investment.





The broader enabling environment for FDI is largely identical with best practices for creating a dynamic and competitive domestic business environment. The principles of transparency (both as regards host country regulatory action and business sector practices) and non-discrimination are instrumental in attracting foreign enterprises and in benefiting from their presence in the domestic economy. FDI is unlikely unless investors have a reasonable understanding of the environment in which they will be operating (see also Figure 4). Moreover, a lack of transparency may lead to illicit and other unethical practices, which generally weaken the host country's business environment. In this context, host-country authorities should undertake the following measures:

- Strengthen their efforts to consolidate the rule of law and good governance. This includes stepping up efforts against corruption and enhancing policy and regulatory frameworks (e.g. as regards competition, financial reporting and intellectual property protection) to foster a dynamic and well-functioning business sector.
- Work toward increased openness to foreign trade, so the domestic enterprise sector can participate fully in the global economy. The successful elimination of global and regional trade barriers makes participating countries more attractive for FDI, owing to the concomitant expansion of the "relevant" market.
- Enshrine the principle of non-discrimination in national legislation and implement procedures to enforce it through all levels of government and public administration. Given the importance of

competition for resource allocation and sustained economic growth, it is essential that foreign entrants should be able to compete on the same terms as national companies.

To reap the maximum benefits from corporate presence in a national economy, domestic competences, technologies and infrastructure need to be sufficiently well developed to allow nationals to take full advantage of the spillovers that foreign-owned enterprises generate. Host-country authorities should therefore (with due regard to the balance between costs and expected benefits and the state of development of the domestic economy) consider undertaking measures to the following effect:

- Put in place, and raise the quality of, relevant physical and technological infrastructure. The presence of such infrastructure is instrumental in attracting MNEs, in allowing national enterprises to integrate the technological spinoffs from foreign-owned enterprises in their production processes, and in facilitating their diffusion through the host economy.
- Given the importance of basic, widespread education for development, raise the basic level of education of national workforces. The provision of specialised skills beyond basic education should build on existing competences in the host economy, rather than target the short-term or specific needs of individual foreign-owned enterprises.
- Implement internationally agreed standards. Efforts to reduce child labour, eliminate workplace discrimination and remove impediments to collec-

tive bargaining are important in their own right. They also serve as tools to upgrade the skills and raise the motivation of the labour force and facilitate linkages with MNEs operating on higher standards. ■

What should home countries do?

While host-country authorities should bear the brunt of the policy adjustments needed to reap the benefits of FDI for development, the home countries of MNEs – and the developed world more generally – need to review the ways in which their national policies affect developing countries.

Further trade liberalisation would contribute substantially to worldwide economic development, benefiting both developed and developing countries. In the FDI context, the trade policies of developed (home) countries gain a further dimension, insofar as an important share of FDI is contingent upon subsequent trade between related enterprises. Trade barriers and subsidies aimed at limiting imports into developed countries currently impose costs on developing countries. The authorities in developed countries could enhance developing countries' ability to attract foreign investment by working to reduce and eventually eliminate these barriers and subsidies.

Home-country governments need to assess the effects that their technology policies may have on the transfer of technologies to the host economy. Authorities can contribute to a positive outcome by encouraging MNEs to consider the technological needs of host countries. The OECD Guidelines for Multinational Enterprises, which adhering countries are committed to promote, stipulate that enterprises should adopt practices that “permit the transfer and rapid diffusion of technologies and know-how, with due regard to the protection of intellectual property rights”.

Another area of action relates to improving the synergies between FDI flows and official development assistance (ODA). There is evidence to suggest that carefully targeted development assistance may assist in leveraging FDI flows and creating a virtuous circle of increasing savings and investment. ODA can be used to buttress or develop institutions and policies in developing countries. This helps create a favourable

environment for domestic savings, and for domestic and foreign investment and growth. ■

What should the enterprise sector do?

The private sector (notably foreign investors) plays a vital role in generating economic growth, and contributing to achieving sustainable development goals. Therefore, the way private enterprises behave and are governed is important in maximising the benefits of FDI for economic development. OECD countries have launched several initiatives to promote responsible corporate behaviour. Among these are the OECD Guidelines for Multinational Enterprises.

Along with provisions for national treatment and other elements of the OECD Declaration on International Investment and Multinational Enterprises, voluntary principles and standards for responsible business conduct are provided by the Guidelines for Multinational Enterprises, recommended by 37 OECD and non-OECD governments to MNEs operating in and from their countries. These recommendations can be read as an approach to the Development Agenda now facing the international community in areas such as technology transfer, human capital management practices, transparency and competition. Moreover, companies should refrain from seeking exemptions from national environmental, labour and health standards.

Multinational enterprises have attempted to respond to public concerns by issuing policy statements, or codes of conduct, which set forth their commitments in various areas of business ethics and legal compliance. Management systems have been designed to stimulate compliance with these commitments, and a number of standardised management systems have emerged. Governments, business associations and other stakeholders can use the Guidelines to support these initiatives and enlist a larger number of companies in the search for best development practices. ■

For further information

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For further reading

- **Foreign Direct Investment for Development. Maximising Benefits, Minimising Costs, 2002**
ISBN: 92-64-19927-6, 50euros, 232p.
- **Forty Years' Experience with the OECD Code of Liberalisation of Capital Movements, *Forthcoming***
ISBN: 92-64-17612-8, 42euros, 150p.
- **International Investment Perspectives, No. 1, 2002**
ISBN: 92-64-19917-9, 40euros, 208p.
- **Policy Competition and Foreign Direct Investment, 2000,**
ISBN: 92-64-17197-5, 28euros, 142p.
- **Reviews of Foreign Direct Investment: Israel, 2002**
ISBN: 92-64-19815-6, 25euros, 152p.
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