GLOBAL FORUM ON
INTERNATIONAL INVESTMENT

ATTRACTING FOREIGN DIRECT INVESTMENT FOR DEVELOPMENT

Shanghai, 5-6 December 2002

FOREIGN DIRECT INVESTMENT FOR DEVELOPMENT: MAXIMISING BENEFITS, MINIMISING COSTS

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Introduction

1. The proper question to ask about globalisation is not whether one personally likes or dislikes it. Globalisation is a fact, and the key question is how to manage it as a force for global welfare and development. This poses important policy challenges for all countries, developed, developing or transition alike. This is why the Doha Development Agenda, the Monterrey Consensus, the New Partnership for Africa's Development, the 2002 OECD Ministerial and the Johannesburg World Summit have all underscored the importance of international investment as a priority area for further analysis and capacity building in achieving sustainable development goals and ensuring that poor countries are not left behind and benefit from globalisation.

2. The recent OECD report *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*[1] -- a result of extensive work and consultation by the OECD investment policy community represented by the Committee on International Investment and Multinational Enterprises -- responds to the international community's reinvigorated efforts to mobilise FDI in support of

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sustainable development. The report, surveying evidence from around the world of linkages between inward FDI and economic development, addresses a wide number of issues, among which:

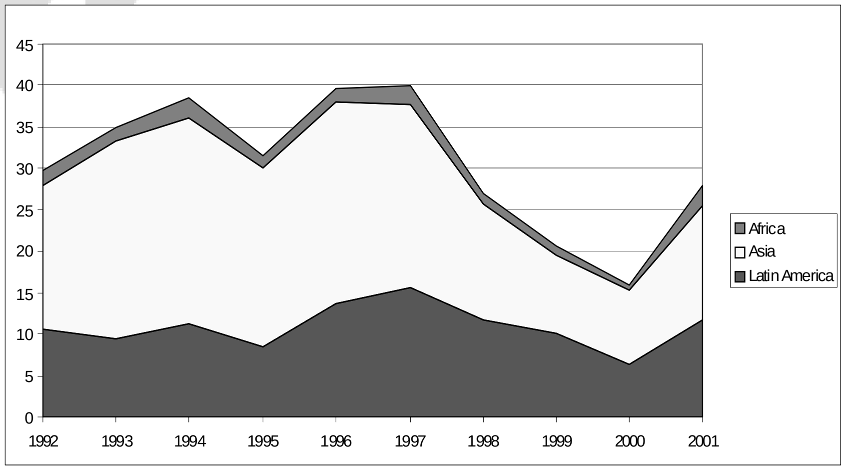
- What is the impact of FDI on macroeconomic growth?
- What is the link with trade integration?
- How can FDI best contribute to technology diffusion and human capital formation in the local economy?
- Is FDI beneficial for sound competition, enterprise restructuring and corporate governance?
- How does it affect social and environmental performance of the host countries?
- What are the policy requirements to maximise the benefits and minimise the costs of FDI?

Recent FDI trends

3. The impact of cross-border investments on the world economy has risen dramatically over the past decades. Between 1973 and 2000 worldwide annual FDI flows increased fifty-fold from $25 billion to $1.271 billion. The contribution of FDI to world welfare (the cumulative GDP of all countries) rose to 17 percent compared with a mere 6 percent in 1980. Developing countries, emerging economies and countries in transition increasingly see FDI as a source (and not a panacea) of economic development. 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.

4. One commonly heard objection against the importance of FDI for development is that developing countries receive only a small share of global FDI flows. This may be exemplified by the following chart.

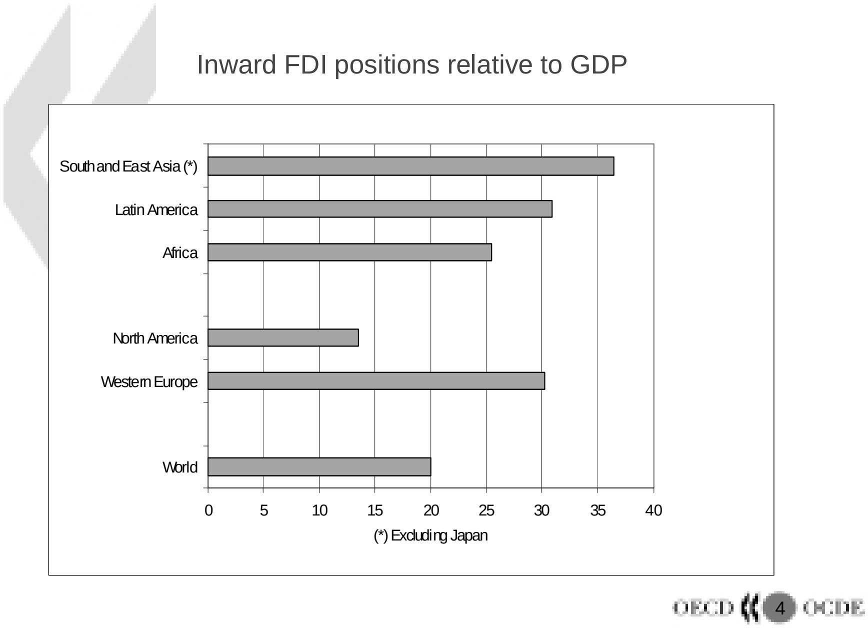
Developing countries’ share of global FDI inflows



5. The relatively low share of FDI to poorer nations needs to be tempered by a couple of observations. First, the relatively low share of developing country FDI in recent years reflects the “investment bubble” in the rich countries in the late 1990s and year 2000. Developing countries continued to attract FDI during this period. Second, the figure suggests that the present slowdown in FDI -- which already halved FDI flows between the largest economies in 2001 -- could return the share of developing countries to their long-term average of about one third of global direct investment flows.

6. The beneficial effects of FDI for development has also been cast in doubt by some on the grounds that those funds that do flow to developing economies are concentrated on a few countries.

7. It is certainly true that in 2001, China, Hong Kong, China, Mexico and Brazil received more than half of the $204 billion that went to developing countries. On the other hand, they are also among the very largest developing economies -- albeit in the case of Hong Kong, together with the mainland China. Thus, one can also present things a bit differently. The potential benefits of FDI are perhaps best measured by the extent of foreign corporate presence relative to the size of the host economy. Using inward FDI positions as a proxy, this is what one gets.



8. Measured this way, developing South and East Asia are the world's principal recipients of FDI. Also, all developing regions are above world averages and, in particular, they are way above the highly developed economies of North America. In other words, on average developing countries are well-placed to reap the benefits of FDI. Still, there could be excessive concentration within the regions.

How does FDI contribute to development?

9. As something perhaps new, the report does not limit itself to surveying the *benefits* of FDI. It also looks into possible drawbacks of FDI -- the so-called "costs". The economic costs of FDI, where they occur, mostly take the form of unintended side effects to the benefits. Hence, they should not be seen in isolation. The side effects have been found to include the distributional consequences of enterprise restructuring; competition effects where foreign entry results in greater market concentration; and balance of payments volatility in response to the import and export patterns of foreign-owned enterprises. It must, however, be stressed that most such "costs" are generally of a short duration and can be corrected through appropriate host country policy measures.

10. The report focuses on the overall effect of FDI on macroeconomic growth and other welfare-enhancing processes. It offers an analytic synthesis of all the work that has been undertaken in the area of FDI and development. As such, it draws on studies by OECD, other international organisations and a wide selection of academia. Investment generally improves a country's economic performance, but FDI carries additional advantages. These manifest themselves essentially through several channels:

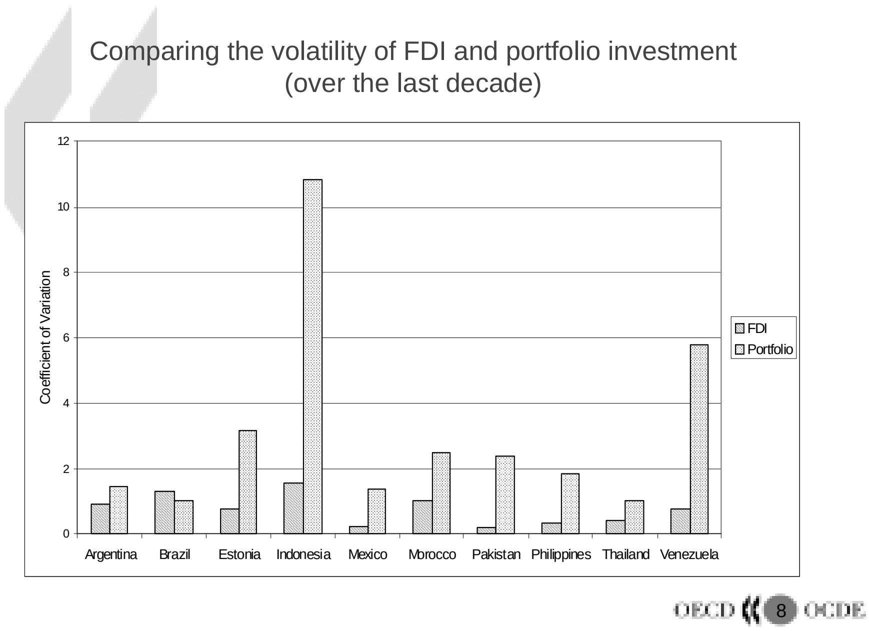
FDI and macroeconomic growth

11. When one undertakes a survey study such as the Foreign Direct Investment for Development, one question immediately springs to the forefront: Why should investment have to be

foreign investment? We all know that investment is good for productivity growth, technological progress, incomes and so on, but what may be the specific advantages of attracting foreign investors? The OECD argues that the advantages are threefold:

12. First, some developing countries have domestic savings that are too low to finance an optimal rate of capital-building. If, at the same time, they have problems tapping international financial markets, FDI may be their best chance of alleviating financing constraints. A similar effect occurs where domestic savings may be ample, but a deficient banking system is unable to funnel the available funds to domestic investors.

13. Second, FDI is a more stable source of external finance than portfolio investment and borrowed funds. For example, in the case of financial crises, loans and short-term securities investment are usually eliminated very swiftly. Investors with a direct stake in enterprises normally stay put. Popularly speaking, direct investors are in for the long haul. This can for instance be illustrated by a comparison of the variability of FDI versus portfolio investment into developing countries over the last decade. In all countries except Brazil the direct investment flows have displayed significantly less volatility.



14. Finally, and perhaps most importantly, countries at all levels of development may benefit from foreign corporate presence in their business sectors. The report identifies three classes of advantages that foreign presence may bring. These are, in fact, the main focus of the report.

FDI and trade integration

15. As countries develop and approach industrialised-nation status, inward FDI contributes to their further integration into the global economy by engendering foreign trade flows.

16. 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 investors' subsequent access to importing and exporting. This implies that countries looking to attract investors should consider a policy of openness to international trade as central in their strategies. This may for instance be achieved through participation in regional free trade arrangements

17. 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 where inward investment helps host countries that had been financially constrained make use of their resource endowment or their geographical location. However, the experience with targeted strategies -- notably the so-called export-processing zones -- has been mixed. 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.

18. 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

19. The spillovers (or "positive externalities") generated by FDI fall into two categories, namely technology diffusion and human capital building. FDI brings new technologies into developing countries, which are eventually diffused to the broader domestic business sector. The channels through which this may take place are legion, but the OECD report concludes that the most important source of technology spillovers is "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.

20. However, there appears 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 beyond 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 than domestic investment on productivity, 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

21. 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. Like is the case with technology, where a significant "knowledge gap" is allowed to persist between foreign entry and the rest of the host economy, no significant spillovers are likely.

22. 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 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 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.

23. 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

24. The direct efficiency gains from FDI fall in two main categories: effects on competition and impacts on enterprise restructuring and development.

25. As for competition, since the early 1990s due to a wave of M&As that 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 has attracted considerable FDI (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, the report suggests that the effect of FDI on host-country concentration is, if anything, stronger in developing countries than in more mature economies.

26. 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.

27. 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

28. Foreign-orchestrated take-overs 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 take-over. 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.

29. 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. 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.

30. 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 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

31. It is important to stress that 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.

32. Taking the latter point first, the OECD study concludes 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.

33. 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. True, there has been anecdotal evidence of MNEs moving equipment that was deemed environmentally unsuitable in the home country to their affiliates in developing countries, but this does not seem to represent a more general trend.

34. The OECD report also finds little support for the assertion that 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 to try to avoid them so great -- that most MNEs allocate production to developing countries regardless of these countries’ environmental regulations. Unsurprisingly, this is particularly the case where investors’ home countries are wealthy or very environmentally concerned.

35. On the other hand, 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. 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.

36. There is also 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.

Policies Matter

37. The OECD report's policy conclusions fall into three categories, namely recommended policy action by host country authorities, by home countries and by the international business community itself. The benefits do, however, not occur automatically. One of the key conclusions of the report is that FDI tends to compound both the advantages and the disadvantages of a country's business environment. Only enterprises that operate in a generally sound environment (nationally as well as internationally) can bring the full benefits of FDI to bear on the host economy. More specifically:

What should host countries do?

38. Most of the effort befalls policy makers in the host countries. The "usual" observations about the essential need for a sound host economy business environment applies equally to the case of attracting and benefiting from FDI. Host country transparency and the rule of law are listed among the top concerns of investors that policies toward attracting FDI must address to be successful. Another very important aspect is the size of the host economy, as for example evidence by China's success with attracting FDI. Even small countries can boost the size of "their" market by pursuing policies of general openness to trade and regional trade integration.

39. First and foremost, sound policies for attracting FDI and benefiting from foreign corporate presence are very similar to policies for mobilising domestic resource. The experience of OECD Members and other countries show 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.

40. 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 policy makers 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.

41. The report finds, based on several surveys of investor motivation, that the two main factors motivating FDI are: (i) the size of the domestic market and (ii) the transparency of corporate and public governance. As for the latter point, FDI is obviously unlikely unless investors have a reasonable understanding of the environment in which they will be operating. Moreover, a lack of transparency may lead to illicit and other unethical practices. 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[2].

- 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 compete without government prejudice.

42. To reap the maximum benefits from corporate presence in a national economy, domestic competences, technologies and infrastructure need to be sufficiently well developed. Otherwise nationals are not equipped to take full advantage of the spillovers that foreign-owned enterprises generate.

43. Host-country authorities should therefore 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 spin-offs from foreign-owned enterprises in their production processes, and in facilitating their diffusion through the host economy.

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2. The OECD recently did a survey of enterprises investing into Eastern and South Eastern Europe. They were asked to list -- apart from the market size -- the top ten factors that made them decide on where to locate. No less than seven of these factors have directly or indirectly to do with transparency and the rule of law. Another piece of supporting evidence was provided by a study undertaken for the Asian Development Bank last year. This study made the most ambitious attempt to day at creating an index measuring the quality of institutional governance in 55 developing and developed countries. There is a clear correlation between good governance and the ability to attract FDI.

- 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 collective 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?

44. Turning now to the challenges of home countries, the countries in which MNEs are domiciled – and the developed world more generally – need to review the ways in which their national policies affect developing countries.

45. Further trade liberalisation would contribute to worldwide economic development in its own right. In the FDI context, the trade policies of developed 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.

46. 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".

47. Another area of action relates to improving the synergies between FDI flows and official development assistance. 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. Development assistance 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?

48. 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.

49. 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.

50. 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.

Co-operation with Non-Member Economies

51. A frequent misconception about the OECD is that it works only for its Members -- the “rich country’s club” syndrome. This is not correct. Even if it wants to do so, the OECD cannot afford concentrating wholly on problems that concern only its Members. For example, a review of the Communiqués of the OECD of recent years illustrates the importance they attach to global issues: financial crises, the environment and climate change, electronic commerce, taxation issues, bribery and corruption, competition and anti-trust issues and governance more generally. Such subjects cannot be confined to the OECD countries.

52. The OECD shares its expertise and engages in policy dialogue with more than 70 non-Member economies from all corners of the globe. Why? Because the OECD knows that the destinies of its members are closely tied to those of non-Members around the world. These co-operative relations cover a broad range of topics of mutual interest tapping into the Organisation’s extensive reservoir of knowledge and experience. Free from the possible constraints of bilateral relations, these contacts aim to further economic integration by making the OECD’s experience available to other countries and enabling the OECD to profit from the insights and perspectives of non-Members.

53. In this context, the OECD is committed to working closely with non-member economies and civil society partners in experience sharing and dialogue to enhance the role of international investment as a catalyst for poverty alleviation in the world as a whole.