FOREIGN DIRECT INVESTMENT AND DEVELOPMENT:
A Reassessment of the Evidence and Policy Implications

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Introduction: Enthusiasm or Scepticism about Foreign Direct Investment?

Amidst all the upheaval in capital markets over the past decade, foreign direct investment (FDI) has come to play an unprecedented role as a source of management, technology, and external funding for the developing countries and economies-in-transition. Five-sixths of all capital flows to the less developed world now originate in the private sector, with FDI by far the largest component, climbing to $120 billion per year by the beginning of 1998, nearly half of the total.

Surrounded by instability in equity markets and in international lending, FDI -- where a parent corporation establishes its own affiliate in a host country to engage in production, or processing, or distribution -- is also the most stable source of outside capital. Embodied in plant, equipment, and workforce, it may expand or contract in response to underlying economic conditions, but not “flee” with the rapidity of stock market investors or commercial bank lenders. Moreover, as in the history of financial crises in Mexico and other parts of Latin America, foreign investment flows appear to be prepared to resume rather quickly as economic stability returns to Asia, with the competitive position of those who have local operations strengthened following devaluations and economic restructuring.

But, despite the new-found enthusiasm for the jobs and products created by the presence of foreign firms, the record shows that the impact of FDI on the development process has been problematic in the past. In a sample of 183 foreign investment projects in some thirty countries over almost two decades (up to the early 1980s), a majority (fifty-five to seventy-five per cent) provided large positive benefits to host growth and economic welfare. But in a large minority of cases (twenty-five to forty-five per cent), foreign investment projects had a clear negative impact on host growth and economic welfare.¹

When does FDI -- in particular foreign investment in manufacturing, rather than natural resources or infrastructure² -- contribute most to the development process? When least? What kinds of foreign investment projects are actually harmful to the prospects for development? How can host authorities in the developing countries and the economies-in-transition enhance the positive contribution that foreign manufacturing investors bring to the local industrial base, and avoid negative or damaging consequences? To a large extent, the answers lie in host government policies themselves.


I. The Most Valuable Foreign Manufacturing Investments

Foreign direct investment contributes most to the development process when the affiliate is wholly-owned and fully integrated into the global operations of the parent company. Export performance requirements have, in the past, encouraged this integration process.

The evidence from the sectors where the spread of foreign manufacturing investment has been most extensive -- automobiles and auto parts, petrochemicals, and electronics/computers -- shows that there is an important distinction between investors producing solely for domestic consumption in the (often protected) host economy, and investors using the host country locale as a site from which to strengthen their larger competitive position in international markets.3

Full-scale foreign plants, integrated into the global sourcing network of the parents, provide benefits to the economies where they are located far in excess of the capital, management, and marketing commonly assumed.

Ford in Mexico, General Motors in Brazil, Philips and Sony in Malaysia, Mobil petrochemicals in Indonesia -- aimed at penetrating global as well as domestic markets -- certainly bring high wages and benefits, advanced technology, sophisticated managerial and marketing techniques. But beyond this -- once the parent investors commit themselves to incorporate the output from a host country into a larger strategy to meet global or regional competition -- there is evidence of a dynamic “integration effect”, which provides newer technology, more rapid technological upgrading, and closer positioning along the frontier of best management practices and highest industry standards, than any other method for the host economy to acquire such benefits.

The term “outsourcing” does not at all capture the potent interaction between the home corporation and the (almost always wholly-owned) subsidiary. The Ford, GM, Philips, Sony, or Mobil subsidiary enjoys persistent parental supervision in raising the state of play to major league standards, so to speak, and keeping it there.

The economic benefits from these production systems integrated across borders extend beyond the workers at the foreign-owned plants. Contradicting charges that wholly-owned affiliates only engage in low value-added “screwdriver” operations, there is extensive evidence that these kinds of operations include substantial value-added (including responsibility for design and system-integration) by the affiliates themselves, and generate dynamic backward linkages that provide spill-overs and externalities to local firms in the industry.

Where foreign investors have established automotive and electronics/computer operations in Latin America and Southeast Asia that were oriented to international as well as domestic markets and conducted with wholly-owned subsidiaries, there is evidence of more intensive coaching for suppliers in quality control, managerial efficiency, and marketing than any other means for firms in the local economy to gain these skills.

Indigenous suppliers to these investors often themselves begin to export to other affiliates of the parent in other countries, then to independent buyers in the international marketplace. Once the Mexican automotive sector reoriented its operations from purely internal toward external markets, more than one hundred Mexican suppliers soon achieved sales of more than $1 million per year.4 Six of the ten largest auto parts exporters who emerged during the early outward expansion of the industry were entirely locally-owned.

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Contrary to contemporary perceptions about the rapid pace of globalisation, however, the history of the spread of foreign investment in the automotive, petrochemical, and computer/electronics industries shows that international markets have been quite sluggish in reallocating the global and regional sourcing networks of the major international corporations along lines of comparative advantage. Instead, to capture the dynamic benefits enumerated above, host governments in Latin America and Southeast Asia have had to use a forceful combination of carrots and sticks -- including export subsidies and export performance requirements -- to induce a first mover to reposition the structure of international production. This then triggered a burst of moves and matching moves on the part of international companies within an industry that produced new sourcing patterns involving many billions of dollars of globally competitive exports.

In the automotive, petrochemical, and computer/electronics industries, economic geographers will find the establishment of industrial complexes around Sao Paulo, Minas Gerais, Monterrey, Matamoros, Surabaya, Jubail, and Penang tied to one or two investment decisions on the part of major international companies in these sectors, driven simultaneously by competition at home and export performance requirements in the host country, which then generated follow-the-leader effects on the part of other members of the industry and their suppliers.

In contrast to the conventional condemnation of export performance requirements as a waste of public monies and trade rents to create a weak and uncompetitive dribble of external sales, the record from using export performance requirements in these three sectors has been to generate a new structure of internationally competitive production now in its second decade of expansion. What public support has been expended can be rigorously justified as a worthwhile transitory method to “lock into” the parents’ externality-filled sourcing network (differentiating this approach, consequently, from simply subsidising all exporters).

In designing host country policies for the future, is the appropriate conclusion that export performance requirements should, therefore, now be considered a legitimate tool of public policy for developing countries and economies-in-transition? Or, should developing countries and economies-in-transition be willing to control and limit the use of export performance requirements as part of some larger policy bargain among capital-importing and capital-exporting nations, rich and poor?
The answer to these questions -- and an explanation of why the deployment of export performance requirements may have been a good tactic for developing countries and economies-in-transition in the past, but a bad strategy for the future -- must await consideration of other more harmful and more troublesome problems in the treatment of international investors.

II. The Most Harmful Foreign Manufacturing Investments

Foreign direct investment is most likely to be harmful -- actually damaging -- to the growth and welfare of the developing countries and the economies-in-transition when the investor is sheltered from competition in the domestic market and burdened with high domestic content, mandatory joint venture and technology-sharing requirements.

There is a common assumption that if international companies conduct their activities with the same “good citizenship” standards abroad as at home their contribution to the host economy can only be positive. But this reasoning hinges, implicitly, on the presence of highly competitive conditions that are fundamentally at odds with both theory and evidence about foreign investment behaviour. In fact, foreign direct investment typically originates in international industries where there are high barriers to entry and deploys itself in domestic markets in the developing countries and economies-in-transition where there are high degrees of concentration. Quite apart from important specific potential harmful activities (like permitting pollution, carrying out operations with inadequate health and safety standards, or tolerating the behaviour of abusive subcontractors) that could be righted by common “good citizenship” standards for behaviour at home and abroad, the possibility that foreign investment might lead to fundamental economic distortion and pervasive damage to the development prospects of the country is ever present.

The key variable is the degree to which the injection of foreign investment into the host economy brings with it an increase in competition in the sector or sub-sector where it occurs -- an increase often derived from the influx of multiple investors simultaneously, with freedom to source their inputs from the local economy or abroad -- or a decrease in competition, with particular investors and particular suppliers awarded exclusive domain over the given sector or sub-sector.

The most frequently used intervention on the part of host authorities in the developing countries and economies-in-transition -- insisting that foreign investors meet high domestic content requirements in tightly protected markets -- falls into the latter category, of stifling rather than enhancing competition. Inviting foreign firms to invest under such conditions has a demonstrably negative impact on the hosts’ prospects for development -- effective rates of protection ranging from 50 percent to more than 600 percent, prices 200 percent to 300 percent higher than the cost for comparable products outside the host economy, intensity of use of those products reduced to less than half of what might be expected by international standards -- an impact sufficiently negative that the host society would often be better off not receiving the foreign investment at all. Yet developing countries and economies-in-transition continue to find ways to protect foreign investors who promise high domestic content levels, despite Uruguay Round pledges to phase out such practices.

The resulting operations are not only highly inefficient, but the infant industry rationale of trying to demonstrate the underlying appeal of a given host to multinational corporations is ineffective. Except in the largest countries, economies of scale are seldom realised, and there are weak incentives for the foreign firms to upgrade technology, or to maintain highest standards of quality control and improvement of human resources. Contrary to conventional expectation, backward linkages to domestic suppliers are less
sophisticated and exhibit fewer indications of training, assisting, or providing technological and marketing externalities than foreign operations with fewer restrictions.

The imposition of high domestic content requirements in protected markets tends moreover to generate a perverse political economy in which foreign investors themselves frequently join domestic forces in opposing further liberalisation of trade and investment. The case of IBM’s proposal for an outward-oriented production facility in Mexico, in return for wholly-owned status and much greater freedom over sourcing of inputs -- a proposal that marked a turning point in Mexico’s approach to foreign investment -- shows heavily-protected Hewlett-Packard and Apple helping to wage the fight within the higher echelons of the Mexican political establishment, in vain, against the IBM initiative and the policy shift it represented. There is similar evidence from contemporary Eastern Europe, where Suzuki (in Hungary) and Fiat (in Poland) have successfully lobbied for continued, even increased trade restrictions to safeguard their small domestic assembly operations, allying with local workers and suppliers to slow the prospects for accession into the European Union.

For both economic and political reasons, therefore, protecting foreign investors in return for high domestic content levels generates a drag on economic growth and the creation of higher standards of living. Instead of the foot-dragging and obfuscation that is taking place in some countries, strict adherence to obligations under the WTO to phase out domestic content requirements rapidly and thoroughly is squarely in the host countries’ own interest.

III. Problematic Operations: Mandatory Joint Ventures and Technology-Sharing Requirements

While imposing domestic content requirements on foreign investors may produce the most damaging consequences for developing countries and economies-in-transition, two of the other most popular approaches in the treatment of foreign firms -- joint venture mandates and technology licensing mandates -- also have negative impacts, and are highly questionable as policy tools.

For many kinds of operations, the joint venture relationship offers benefits to all parties. When the partnership is required rather than spontaneous, however, rates of dissatisfaction are intense, with the likelihood of dissolution within a few years high. US and European parent firms shun joint venture arrangements where international sourcing, quality control, rapid technological change, product differentiation, and integration with external markets rather than purely domestic sales dictate corporate strategy; Japanese firms may now be exhibiting the same tendency.

Many host governments justify joint venture requirements with arguments that joint ventures achieve greater technology transfer, expanded access to external markets, and more robust backward linkages to the domestic economy than wholly-owned subsidiaries. None of these contentions is supported by the data. Technology


transferred to joint ventures is older (almost one-third older) and speed of upgrading is slower than to wholly-owned subsidiaries. Export performance is comparatively weak. Joint ventures may purchase more inputs from indigenous firms, but their sourcing networks lack most of the technological, managerial, and export marketing spill-overs for local suppliers that comes from the more potent relationship with the parent corporation in the case of wholly-owned subsidiaries, described earlier.

As for technology licensing requirements as a substitute for FDI (the so-called “Japan-Korea” model), the evidence shows that indigenous corporate operations that are built via mandatory technology licensing are likely to suffer the same kind of economic disadvantages as joint ventures: lags in technology acquisition, absence of “best management” techniques, weak penetration of foreign markets, and feeble performance in development of a competitive supplier base.

The adoption of a strategy to build national champions via mandatory technology licensing (to the exclusion of foreign investment and foreign acquisitions) opens the door, inevitably, to the core “industrial policy” problem of special pleading and special preferences on the part of powerful rent-seeking constituencies who may well not be able to distinguish their own self-interest from their interpretation of the national interest. Learning from the Asian financial crisis of 1997-98, there is reason to doubt that a system of import restraint and export promotion that focuses on chosen sectors and preferred national firms, powered by state-dictated technology licensing arrangements, can ever escape the political-economic corruption and “crony capitalism” that have figured so prominently in the history of many Asian economies.

As for political benefits from autonomy, the extent to which maintaining ownership in national hands has a legitimate national security rationale -- to avoid monopolistic external suppliers who might delay, deny, or set conditions upon the use of inputs -- is quite limited, and the drawbacks in terms of cost and performance that self-sufficiency imposes are quite large.

IV. The Counter-Attack by the Developed Countries against Globalisation

But, while domestic, joint venture and technology licensing requirements are all ill-advised methods to capture the benefits from FDI, it would be mistaken to suppose that, in their absence, host authorities in the less developed world are best advised merely to sit back, improve the “fundamentals” in their own economies, and wait for international markets to deliver appropriate amounts of foreign investment to their countries.

Policy strategists in the developing countries and economies-in-transition will require a canvas broad enough to include the investment-attracting and the investment-distorting practices of others, in particular the home countries of the international corporations. In reaction to the globalisation of manufacturing activity, developed countries have launched a counter-offensive of their own to capture and hold international corporate operations within their own economies.

One prong of this counter-offensive has been the growing use of economic carrots and political sticks to keep already-present firms from moving, and to attract new international investment to developed country sites. There are learned disputes about whether Ireland, the eastern regions of Germany, the provinces of Canada, or individual US states lead in this incentive competition. While not every developed country site competes with every developing country site, the evidence from the automotive, petrochemical, and computer/electronics sectors shows nonetheless that international companies are making their location decisions in the midst of a fierce subsidy war in which locational incentives of more than $50,000-$100,000 per job (as calculated by the OECD) are frequently acting as *tie-breakers*, at the margin.

A second prong of the counter-offensive against the loss of productive capacity has been the use of protectionist and investment-diverting trade measures, most notably high domestic content rules of origin and anti-dumping regulations, in a discriminatory and demonstrably distortionary manner.

The United States and the European Union have imitated each other in designing rules of origin -- with high domestic content required to qualify for preferential treatment within a regional trading bloc -- to protect local industries and to shift foreign investment into member states. This complicated mix of protectionism and investment-shifting was evident in the US effort in NAFTA to prevent assembly operations from being set up within the borders of Canada, the United States, and Mexico using low cost inputs from outside. For automobiles, electronic products (printers, copiers, television tubes), textiles, telecommunications, machine tools, forklift trucks, fabricated metals, household appliances, furniture, and tobacco products, NAFTA rules of origin require that a substantial portion of inputs originate in the NAFTA states. The EU has adopted high domestic content rules of origin in semiconductors and has entertained proposals for even tighter requirements for printed circuit boards and telecom switching equipment.

In terms of anti-dumping regulations, investment diversion takes place in two ways: first, indirectly, by generating an obstacle, or an uncertainty, that retards an international firm from investing in potential export operations, and second, directly, by causing the redeployment of production to the market protected by anti-dumping regulations. The easiest way to avoid anti-dumping liability is to establish operations within the market where a company hopes to sell its products rather than exporting to that market from abroad.

Taken together, the central components of the counter-offensive -- locational incentives, high domestic content rules of origin, and anti-dumping regulations -- are not simply being used to protect inefficient industries but more broadly to recast the international economic landscape, along paths that do not follow what comparative advantage would otherwise dictate.

The need to offset these investment-diverting policies on the part of developed countries helps explain (along with evidence of other market imperfections) the crucial role of export subsidies and export performance requirements -- noted earlier -- in inducing international companies to include developing countries and economies-in-transition in their regional or global sourcing networks.

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10 This matter was discussed at the OECD Conference on Trade and Competition held in Paris on 29-30 June 1999. See OECD web site http://www.oecd.org/daf/ech/.
But the temptation to engage in locational subsidy races, or to mimic the self-centred and myopic use of rules of origin and anti-dumping regulations of the developed world, does not offer a path that coincides with the long term interests of these less developed hosts. It leads them into a competition they cannot win, and whose outcome they are likely only to make worse.

What policy agenda, then, should developing countries and economies-in-transition adopt, and pursue, to maximise the contribution that FDI can make to their development process?

V. Maximising Flows of Foreign Direct Investment and the Benefits therefrom

Many of the most important actions that host countries can take to attract and utilise FDI in their development programs they must initiate on their own -- in particular, improving the micro- and macro-economic functioning of their economies, and strengthening commercial and judicial institutions that provide stability and dependability to all investors, domestic as well as foreign.

At the same time, the most important foreign investment policy improvements recommended here -- abandoning the use of domestic content, joint venture, and technology licensing requirements -- could also be adopted unilaterally, to the benefit of host authorities in the developing world and economies-in-transition.

Armed with these insights, development planners might want to reconsider the efficacy of bestowing sole right of establishment upon individual foreign investors or foreign investor groups for each segment of a given industrial sector, while insisting upon partnerships with indigenous firms. These joint operations utilise demonstrably older technology and have a poor record of adopting cutting edge management methods. In the automotive sector -- to give one example -- this approach has already set in place an array of undersized plants more than ten years behind the competitive frontier of new products, processes, and management practices.

To be sure, there is no underestimating how painful the decision will be for hosts and potential hosts in the developing world and transition economies to give up the imposition of domestic content requirements and to forego the use of joint venture and technology licensing mandates. Rules governing local content, ownership structure, and technology acquisition represent a vast pool of favours to bestow upon rent-seeking constituencies, and the abandonment of public sector regulation in these areas is sure to generate powerful opposition.

But there is a broader opportunity to be gained by a forceful redirection of policy here, if the policy reform process can be combined with similar efforts to stem the deployment of protectionist and investment-distorting measures on the part of the developed countries as well.

Unilateral self-abstention from the use of domestic content, joint venture, and technology licensing requirements -- however beneficial the outcome will be to those countries who follow this route -- leaves host authorities in the developing countries and the economies-in-transition tactically disarmed, so to speak, in the face of the “counter-offensive” against the globalisation of industry launched by developed countries, tactically disarmed against the escalation in the use of high domestic content rules of origin, locational subsidies, and distortionary anti-dumping actions that is hindering economic activity from moving along lines of comparative advantage in a North-South direction.

Host authorities in the developing countries and the economies-in-transition might want to think more broadly, therefore, about how they could work collectively to shape the treatment of international corporate activity
around the world, seeking support in such an endeavour among their own counterparts as well as among
developed country governments. The elements of what constitutes sensible self-interested policies toward FDI
outlined here are in fact well-suited to assertive negotiations in the next trade Round, incorporating trade-offs
among the most objectionable investment-related policies of all parties, North and South.

In the review of the TRIMs agreement, for example, in which the developing countries have committed
themselves to ending all domestic content and trade- and financial-balancing requirements on foreign firms,
developing countries will find it in their own self-interest to phase out such practices as rapidly as possible.
But developing countries will want to note the increasing use of high domestic content rules of origin that
create the same distortions within the NAFTA region, the EU, and Mercosur as well. The technical trade-law
defence of the latter, originating in Article 24 of the GATT which allows preferential trade agreements as long
as those agreements do not raise external tariffs against outsiders, has justifiably been receiving critical scrutiny
for shielding the same protectionist practices as the TRIMs agreement has been trying to eliminate.
Considerations of consistency and fairness dictate, therefore, that the WTO’s work programme on
harmonisation of non-preferential rules of origin be transformed into an exercise on harmonisation (and
reduction) of high domestic content preferential rules of origin.

Export performance requirements that take the form of trade-balancing or foreign exchange-balancing
obligations are also subject to elimination under the TRIMs agreement. The consideration of such export
performance requirements raises complex strategic considerations. On the one hand, developing countries
have sometimes used such requirements to trigger the reorientation of global and regional sourcing strategies
on the part of multinational investors. On the other hand, developing countries would benefit from restraining
the competition for world scale-sized investment facilities among themselves and between themselves and
developed countries.

Once the principle of avoiding subsidy competition for export-oriented production becomes the guide for
developing country policymakers, however, it is not logical for developing country negotiators to disregard
other interventions to hold or attract world scale-sized facilities, in particular the award of locational incentives
(including subsidies and tax breaks on the national and sub-national level) that perform the same function in
reshaping patterns of international production.

Ireland’s fiscal incentive programmes to draw international firms into using the country as an export platform
into the European Union, for example, are similar in impact to the trade-balancing TRIMs that propelled
Mexico and Brazil into the ranks of international auto parts suppliers (albeit simpler and neater from an
economic point of view). More generally, given the new econometric evidence on the high response rate of
production location on the part of international firms to differential incentive structures, it is disingenuous to
conclude that the investment incentive packages of Alabama or South Carolina do not alter trade patterns while
the export performance requirements of developing countries do.

In the negotiations of the next trade Round, developing countries might offer to refrain from all new export
performance requirements and to phase out existing requirements within ten years (as specified, for example,
in the NAFTA) in exchange for a commitment on the part of the world trade community to subject the use of
locational incentives, at the national and sub-national level, to simultaneous restraint.

Joint venture and technology-sharing requirements are not included in the illustrative list of the TRIMs
Agreement. The demonstration of the drawbacks that joint venture and technology-sharing mandates impose
on the ability of host countries to compete in the international marketplace, however, opens a broad new vista
for developing country negotiations.
As the appreciation of the detrimental impact of joint venture and technology-sharing requirements, along with domestic content and (possibly) export requirements, increases, the rationale for awarding national treatment to some foreign firms and denying right of establishment to others in return for meeting such requirements disappears. The pledges of foreign firms about which local companies they will choose as partners or about what technology the foreigners will provide to indigenous participants in their projects have been the predominant elements (along with promises about how much local content they will purchase and about the degree to which they will export) in host country determinations of whether to award right of establishment, on the one hand, or deny national treatment, on the other.

This opens the door to the possibility that developing countries might want to propose the negotiation of new multilateral investment rules (albeit with a fresh name) which serve the interests of developed and developing countries alike.

But if developing countries show a willingness to put national treatment and right of establishment on the negotiating table, in a major move toward letting comparative advantage be the sole criterion for the deployment of FDI around the world, they should aim at having the world community complete the list of investment-shifting and investment-distorting measures, by adding not just discipline on high domestic content rules of origin and locational incentives to the negotiations, as indicated before, but by including anti-dumping reform as well.

Anti-dumping reform would limit the definition of what constitutes unfair practice to international price discrimination, and would abandon the protectionist and discriminatory use of average-cost-plus-mark-up in determining guilt. This reform would have vast implications for the ability of developing countries to utilise indigenous as well as multinational firms in penetrating international markets.

To be successful in extracting concessions from the developed countries, however, the developing countries and economies-in-transition will have to ensure that blocking coalitions do not emerge from within their own ranks. Reformers in Latin American countries such as Brazil, Argentina, Chile, and Mexico, for example, may have to join reformers from India, China, Egypt, and the Philippines to edge the governments of the latter away from the lingering desire to maintain domestic content or joint venture requirements. Similarly, the members of regional groupings such as Asean or Mercosur will have to sublimate their urge to deploy investment incentives against each other into global limitations on locational subsidies.

In short, a potent negotiating strategy in the next trade Round will depend upon the ability of leaders from the developing and transition economies to weave together agreement on sensitive investment policy issues among their own members.

There is no doubt that achieving the changes and reforms in the most objectionable investment-related policies of all parties, North and South alike, will be a long, hard, up-hill battle, with the outcome highly dependent upon the ability of visionaries in developed and developing countries to galvanise the international business community to deploy its clout on the side of multilateral reform. But at least it is possible to see more clearly now what kinds of trade-offs are essential and what kind of outcome would be most beneficial to all parties.