OVERVIEW

Foreign Direct Investment for Development

MAXIMISING BENEFITS, MINIMISING COSTS

OECD

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MAXIMISING BENEFITS, MINIMISING COSTS

Overview

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Note by the editor

This report was prepared within the framework of the activities of the Committee on International Investment and Multinational Enterprises (CIME). It is based on a study by the OECD Secretariat, which was reviewed by members and observers in the Committee at its meetings in December 2001 and April 2002. The process included consultations with the Business and Industry Advisory Committee, Trade Union Advisory Committee and other civil society partners of the Committee. This report has been approved for publication by the Committee.

Introduction

Foreign direct investment (FDI) is an integral part of an open and effective international economic system and a major catalyst to development. Yet, the benefits of FDI do not accrue automatically and evenly across countries, sectors and local communities. National policies and the international investment architecture matter for attracting FDI to a larger number of developing countries and for reaping the full benefits of FDI for development. The challenges primarily address host countries, which need to establish a transparent, broad and effective enabling policy environment for investment and to build the human and institutional capacities to implement them.

With most FDI flows originating from OECD countries, developed countries can contribute to advancing this agenda. They can facilitate developing countries' access to international markets and technology, and ensure policy coherence for development more generally; use overseas development assistance (ODA) to leverage public/private investment projects; encourage non-OECD countries to integrate further into rules-based international frameworks for investment; actively promote the OECD Guidelines for Multinational Enterprises, together with other elements of the OECD Declaration on International Investment; and share with non-members the OECD peer review-based approach to building investment capacity.

Summary and Conclusions

The present study focuses on maximising the benefits of foreign corporate presence…

Developing countries, emerging economies and countries in transition have come increasingly to see 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 study Foreign Direct Investment for Development attempts primarily to shed light on the second issue, by focusing on the overall effect of FDI on macroeconomic growth and other welfare-enhancing processes, and on the channels through which these benefits take effect.

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 also taking stock of the possible costs and proposing ways to reduce them.

The report does not focus solely on the positive effects of FDI for development. It also addresses concerns about potential drawbacks for host economies, economic as well as non-economic. While many of the drawbacks, referred to as "costs" in this report, arguably reflect shortcomings in the domestic policies of host countries, 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), a lack of positive linkages with local communities, the potentially harmful environmental impact of FDI, especially in the extractive and heavy industries, social disruptions 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. Even some expected benefits may prove elusive if, for example, the host economy, in its current state of economic development, is not able to take advantage of the technologies or know-how transferred through FDI.

I. Trends

FDI hit new records in 1999 and 2000...

The magnitude of FDI flows continued to set records through the last decade, before falling back in 2001. In 2000, world total inflows reached 1.3 trillion US dollars

Table 1. **OECD FDI outflows by region**

	In USD million				Percentage of total			
	1985	1990	1995	2000	1985	1990	1995	2000
WORLD	61 277	235 836	335 194	1 068 786	100	100	100	100
of which:								
OECD countries	42 055	189 166	263 716	904 349	68.6	80.2	79.7	84.6
Non-OECD countries	19 222	46 670	71 437	137 747	31.4	19.8	21.3	12.9
of which:								
Africa	404	195	3 100	7 267	0.7	0.1	0.9	0.7
Asia*	2 171	12 650	25 106	29 494	3.5	5.4	7.5	2.8
Europe*	8	408	3 570	14 026	0.0	0.2	1.1	1.3
Latin America and Caribbean*	9 101	18 948	23 632	68 374	14.9	8.0	7.1	6.4
Near and Middle East	212	1 056	1 936	1 571	0.3	0.4	0.6	0.1
Unallocated	7 325	13 413	14 093	17 015	12.0	5.7	4.2	1.6

* Excluding OECD countries.
Source: OECD *International Direct Investment Statistics*.

(USD) – or four times the levels of five years earlier. More than 80% of the recipients of these inflows, and more than 90% of the initiators of the outflows, were located in "developed countries". A breakdown of the outflows from OECD countries is provided in Table 1.

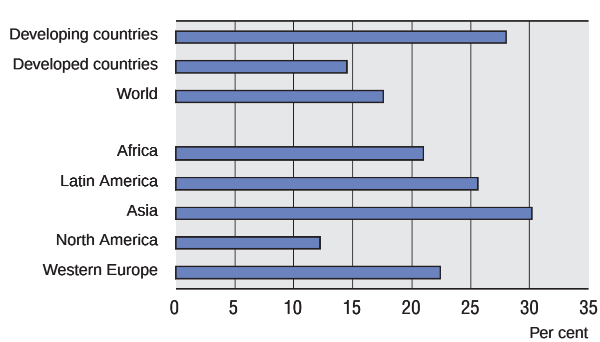
... and although developed countries were the main recipients, developing countries also received economically significant sums...

The limited share of FDI that goes to developing countries is spread very unevenly, with two-thirds of total FDI flows from OECD members to non-OECD countries going to Asia and Latin America. Within regions there are some strong concentrations on a few countries, such as China and Singapore in the case of Asia. Even so, FDI inflows represent significant sums for many developing countries, several of them recording levels of FDI, relative to the size of the domestic economy, that overshadow the largest OECD economies (Figure 1). Moreover, the flow of FDI to developing countries worldwide currently overshadows official development assistance by a wide margin, further highlighting the need to address the use of FDI as a tool for economic development. The African continent's apparent problem with attracting FDI is briefly discussed in Box 1.

... mainly in the form of greenfield investment.

In recent years, an increasingly large share of FDI flows has been through mergers and acquisitions (M&As). This partly reflects a flurry of transatlantic corporate takeovers, and partly the large-scale privatisation programmes that

Figure 1. **Inward FDI stock, 2000 (share of GDP)**



Source: UNCTAD.

Box 1. Inward FDI in Africa

The entire African continent (except South Africa) received FDI inflows worth an estimated US$ 8.2 billion in 2000. For comparison, this equals the amount of inward FDI attracted by Finland this year, and it represented a mere 0.6 per cent of total world FDI flows. Several recent studies have discussed the possible reasons for this seemingly spectacular failure of African countries at attracting foreign investors.

The main factors motivating FDI into Africa in recent decades appear to have been the availability of natural resources in the host countries (*e.g.* investment in the oil industries of Nigeria and Angola) and, to a lesser extent, the size of the domestic economy. The reasons for the lacklustre FDI in most other African countries are most likely the same factors that have contributed to a generally low rate of private investment to GDP across the continent. Studies have attributed this to the fact that, while gross returns on investment can be very high in Africa, the effect is more than counterbalanced by high taxes and a significant risk of capital losses. As for the risk factors, analysts now agree that three of them may be particularly pertinent: macroeconomic instability; loss of assets due to non-enforceability of contracts; and physical destruction caused by armed conflicts.[1] The second of these may be particularly discouraging to investors domiciled abroad, since they are generally excluded from the informal networks of agreements and enforcement that develop in the absence of a transparent judicial system.

Several other factors holding back FDI have been proposed in recent studies, notably the perceived sustainability of national economic policies, poor quality of public services and closed trade regimes.[2] Even where the obstacles to FDI do not seem insurmountable, investors may have powerful incentives to adopt a wait-and-see attitude. FDI (and especially greenfield investment) contains an important irreversible element, so where investors' risk perception is heightened the inducement would have to be massive to make them undertake FDI as opposed to deferring their decision.[3] This problem is compounded where a deficit of democracy, or of other kinds of political legitimacy, makes the system of government prone to sudden changes. Finally, a lack of effective regional trade integration efforts has been singled out as a factor.[4] Due to this, national markets remained small and grew at a modest pace (and, in some cases, they even contracted).

A few countries have, however, been able to attract FDI, apparently by virtue of the quality of their domestic business climates. It has been argued that countries such as Mozambique, Namibia, Senegal and Mali in the late 1990s became perceived as having a relatively benign investment environment.[5] This seems to have resulted primarily from government policies toward trade liberalisation; the launch of privatisation programmes; modernising investment codes and adopting international FDI agreements; developing a few priority projects of wider economic impact; and, finally, engaging in high-profile publicity efforts, aimed at informing investors of these improvements.

Box 1. **Inward FDI in Africa** (*cont.*)

1. E. Hernández-Catá (2000), "Raising Growth and Investment in Sub-Saharan Africa: What Can Be Done?", IMF Policy Discussion Paper, PDP/00/4.
2. See, for example, D. Dollar and W. Easterly (1998), "The Search for the Key: Aid, Investment and Policies in Africa", World Bank Working Paper.
3. L. Serván (1996), "Irreversibility, Uncertainty and Private Investment: Analytical Issues and Some Lessons for Africa", World Bank Working Paper.
4. N. Odenthal (2001), "FDI in Sub-Saharan Africa", Technical Paper No. 173, OECD Development Centre.
5. J. Morisset (2000), "Foreign Direct Investment in Africa: Policies also Matter", World Bank Working Paper.

were implemented throughout much of the world in the 1990s. In developing countries, however, greenfield investment has remained the predominant mode of entry for direct investors, followed by foreign companies' participation in privatisations.

II. FDI and growth

Beyond the initial macroeconomic stimulus from the actual investment, FDI *influences growth by raising total factor productivity and, more generally, the efficiency of resource use in the recipient economy. This works through three channels: the linkages between* FDI *and foreign trade flows, the spillovers and other externalities* vis-à-vis *the host country business sector, and the direct impact on structural factors in the host economy.*

The existence of an "additional" growth impact of FDI is widely accepted. The magnitude is less clear…

Most empirical studies conclude that FDI contributes to both factor productivity and income growth in host countries, beyond what domestic investment normally would trigger. It is more difficult, however, to assess the magnitude of this impact, not least because large FDI inflows to developing countries often concur with unusually high growth rates triggered by unrelated factors. Whether, as sometimes asserted, the positive effects of FDI are mitigated by a partial "crowding out" of domestic investment is far from clear. Some researchers have found evidence of crowding out, while others conclude that FDI may actually serve to increase domestic investment. Regardless, even where crowding out does take place, the net effect generally remains beneficial, not least as the replacement tends to result in the release of scarce domestic funds for other investment purposes.

… particularly in the least developed countries, where low educational and technological standards and weak financial markets can hold back the benefits.

In the least developed economies, FDI seems to have a somewhat smaller effect on growth, which has been attributed to the presence of "threshold externalities". Apparently, developing countries need to have reached a certain level of development in education, technology, infrastructure and health before being able to benefit from a foreign presence in their markets. Imperfect and underdeveloped financial markets may also prevent a country from reaping the full benefits of FDI. Weak financial intermediation hits domestic enterprises much harder than it does multinational enterprises (MNEs). In some cases it may lead to a scarcity of financial resources that precludes them from seizing the business opportunities arising from the foreign presence. Foreign investors' participation in physical infrastructure and in the financial sectors (subject to adequate regulatory frameworks) can help on these two grounds.

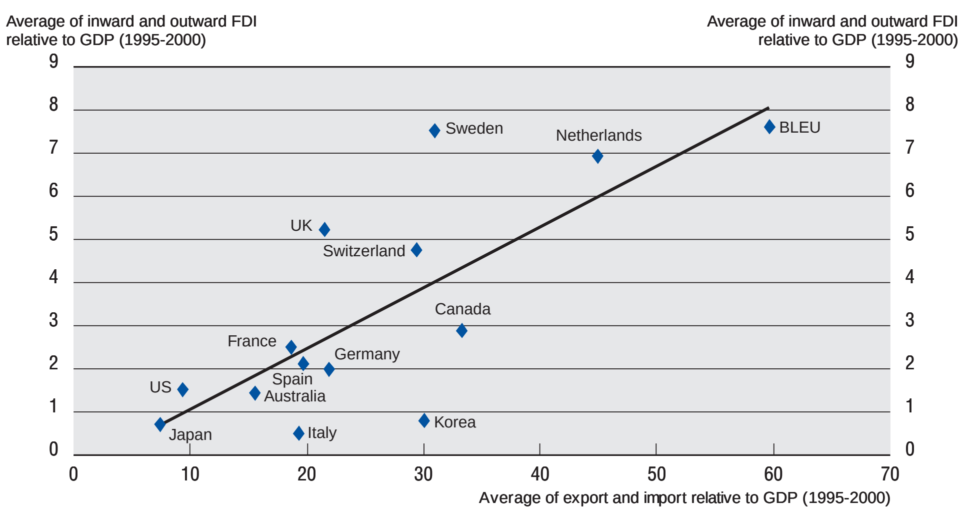
a) Trade and investment

While the empirical evidence of FDI's effects on host-country foreign trade differs significantly across countries and economic sectors, a consensus is nevertheless emerging that the FDI-trade linkage must be seen in a broader context than the direct impact of investment on imports and exports. The main trade-related benefit of FDI for developing countries lies in its long-term contribution to integrating the host economy more closely into the world economy in a process likely to include higher imports as well as exports. In other words, trade and investment are increasingly recognised as mutually reinforcing channels for cross-border activities. However, host-country authorities need to consider the short and medium-term impacts of FDI on foreign trade as well, particularly when faced with current-account pressures, and they sometimes have to face the question of whether some of the foreign-owned enterprises' transactions with their mother companies could diminish foreign reserves.

As countries develop and approach industrialised-nation status, inward FDI contributes to their further integration into the global economy by engendering and boosting 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 and strengthening 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 is influenced significantly by the entrant's subsequent access to engage in importing and exporting activities. This, in turn, implies that would-be host countries should consider a policy of openness to international trade as central in their strategies to benefit from FDI, and that, by restricting imports from developing countries, home countries effectively curtail these countries' ability to attract foreign direct investment. Host countries could consider a strategy of attracting FDI through raising the size of the

FDI generally occurs in tandem with greater international trade integration, which may reflect increasing vertical integration as well as the establishment of transnational distribution networks.

Figure 2. **The openness to FDI and trade**



Source: OECD International Direct Investment Statistics and OECD Economic Outlook.

relevant market by pursuing policies of regional trade liberalisation and integration.

The ability of FDI to contribute to developing export capabilities depends on context. Export-processing zones may be a tool for closer integration into world trade, but they come at a cost.

Host countries' ability to use FDI as a means to increase exports in the short and medium term depends on the context. The clearest examples of FDI boosting exports are found where inward investment helps host countries that had been financially constrained make use either of their resource endowment (*e.g.* foreign investment in mineral extraction) or their geographical location (*e.g.* investment in some transition economies). Targeted measures to harness the benefits of FDI for integrating host economies more closely into international trade flows, notably by establishing export-processing zones (EPZs), have attracted increasing attention. In many cases they have contributed to a raising of imports as well as exports of developing countries. However, it is not clear whether the benefits to the domestic economy justify drawbacks such as the cost to the public purse of maintaining EPZs or the risks of creating an uneven playing field between domestic and foreign enterprises and of triggering international bidding wars.

FDI has generally not been an appropriate tool for import-substitution strategies.

Recent studies do not support the presumption that lesser developed countries may use inward FDI as a substitute for imports. Rather, FDI tends to lead to an upsurge in imports, which is often gradually reduced as local companies acquire the skills to serve as subcontractors to the entrant MNEs.

b) **Technology transfers**

Economic literature identifies technology transfers as perhaps the most important channel through which foreign corporate presence may produce positive externalities in the host developing economy. MNEs *are the developed world's most important source of corporate research and development* (R&D) *activity, and they generally possess a higher level of technology than is available in developing countries, so they have the potential to generate considerable technological spillovers. However, whether and to what extent* MNEs *facilitate such spillovers varies according to context and sectors.*

Technology transfers are an important aspect of MNE presence, particularly through vertical linkages…

Technology transfer and diffusion work via four interrelated channels: vertical linkages with suppliers or purchasers in the host countries; horizontal linkages with competing or complementary companies in the same industry; migration of skilled labour; and the internationalisation of R&D. The evidence of positive spillovers is strongest and most consistent in the case of vertical linkages, in particular, the "backward" linkages with local suppliers in developing countries. MNEs generally are found to provide technical assistance, training and other information to raise the quality of the suppliers' products. Many MNEs assist local suppliers in purchasing raw materials and intermediate goods and in modernising or upgrading production facilities.

… whereas the importance of horizontal linkages is still the subject of debate.

Reliable empirical evidence on horizontal spillovers is hard to obtain, because the entry of an MNE into a less-developed economy affects the local market structure in ways for which researchers cannot easily control. The relatively few studies on the horizontal dimension of spillovers have found mixed results. One reason for this could be efforts by foreign enterprises to avoid a spillover of know-how to their immediate competition. Some recent evidence appears to indicate that horizontal spillovers are more important between enterprises operating in unrelated sectors.

The effect on growth depends on the "relevance" of the foreign technologies, and on the basic technological level of the host country.

A proviso relates to the relevance of the technologies transferred. For technology transfer to generate externalities, the technologies need to be relevant to the host-country business sector beyond the company that receives them first. The 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.

c) Human capital enhancement

The major impact of FDI on human capital in developing countries appears to be indirect, occurring not principally through the efforts of MNEs, but rather from government policies seeking to attract FDI via enhanced human capital. Once individuals are employed by MNE subsidiaries, their human capital may be enhanced further through training and on-the-job learning. Those subsidiaries may also have a positive influence on human capital enhancement in other enterprises with which they develop links, including suppliers. Such enhancement can have further effects as that labour moves to other firms and as some employees become entrepreneurs. Thus, the issue of human capital development is intimately related with other, broader development issues.

Human capital is an essential part of a country's enabling environment. In particular, a certain minimum level of education should be reached...

Investment in general education and other generic human capital is of the utmost importance in creating an enabling environment for FDI. Achieving a certain minimum level of educational attainment is paramount to a country's ability both to attract FDI and to maximise the human capital spillovers from foreign enterprise presence. The minimum level differs between industries and according to other characteristics of the host country's enabling environment; education in itself is unlikely to make a country attractive to foreign direct investors. However, where a significant "knowledge gap" is allowed to persist between foreign entry and the rest of the host economy, no significant spillovers are likely.

... and basic labour market standards should be respected.

Among the other important elements of the enabling environment are the host country's labour market standards. By taking steps against discrimination and abuse, the authorities bolster employees' opportunities to upgrade their human capital, and strengthen their incentives for doing so. Also, a labour market where participants have access to a certain degree of security and social acceptance lends itself more readily to the flexibility that is key to the success of economic strategies based on human capital. It provides an environment in which MNEs based in OECD countries can more easily operate, applying their home country standards and contributing to human capital development. One strategy to further this goal is a wider adherence to the OECD Declaration on International Investment and Multinational Enterprises, which would further the acceptance of the principles laid down in the Guidelines for Multinational Enterprises.

Generic education in the host economy remains essential. Human capital enhancement via foreign subsidiaries may provide a useful supplement...

While the benefits of MNE presence for human capital enhancement are commonly accepted, it is equally clear that their magnitude is significantly 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. The challenge for the authorities is to meet this demand in a timely manner while providing education that is of such general usefulness that it does not implicitly favour specific enterprises.

... especially as MNEs in most cases provide more training than local enterprises.

Empirical and anecdotal evidence indicates that, while considerable national and sectoral discrepancies persist, 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. Policies to enhance labour-market flexibility and encourage entrepreneurship, among other strategies, could help buttress such spillovers.

Technological and educational achievements are mutually reinforcing, which would justify a co-ordinated approach by policy makers.

Human capital levels and spillovers are closely interrelated with technology transfers. In particular, 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. The implication of this is that efforts to reap the benefits of technology and human capital spillovers could gain effectiveness when policies of technological and educational improvement are undertaken conjointly.

d) Competition

FDI *and the presence of* MNEs *may exert a significant influence on competition in host-country markets.* However, *since there is no* *commonly accepted way of measuring the degree of competition in a given market, few firm conclusions may be drawn from empirical evidence. The presence of foreign enterprises may greatly assist economic development by spurring domestic competition and thereby leading eventually to higher productivity, lower prices and more efficient resource allocation. Conversely, the entry of MNEs also tends to raise the levels of concentration in host-country markets, which can hurt competition. This risk is exacerbated by any of several factors: if the host country constitutes a separate geographic market, the barriers to entry are high, the host country is small, the entrant has an important international market position, or the host-country competition law framework is weak or weakly enforced.*

Market concentration has increased in response to M&As and strategies for corporate co-operation…

Market concentration worldwide has increased significantly 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. Alliances are generally thought to limit direct competition while generating efficiency gains, but evidence of this is not firmly established. There has also been a wave of privatisations that has attracted considerable foreign direct investment (mainly in developing and emerging countries), and this, too, could have important effects on competition.

… not least among developing countries…

Empirical studies suggest that the effect of FDI on host-country concentration is, if anything, stronger in developing countries than in more mature economies. This could raise the concern that MNE entry into less-developed countries can be anti-competitive. Moreover, while ample evidence shows MNE entry raising productivity levels among host-country incumbents in developed countries, the evidence from developing countries is weaker. Where such spillovers are found, the magnitude and dispersion of their effects are linked positively to prevailing levels of competition.

… but in most cases not to levels that give rise to immediate concerns about competition.

However, the direct impact of rising concentration on competition, if any, appears to vary by sector and host country. There are relatively few industries where global concentration has reached levels causing real concern for competition, especially if relevant markets are global in scope. In addition, high levels of concentration in properly defined markets may not result in reduced competition if barriers to entry and exit are low or buyers are in a good position to protect themselves from higher prices.

The strategies for avoiding anti-competitive practices include openness to foreign trade and the tightening of domestic competition rules and practices.

While it is economically desirable that strongly performing foreign competitors be allowed to replace less productive domestic enterprises, policies to safeguard a healthy degree of competition must be in place. Arguably 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 advisable to minimise the anti-competitive effects of weaker firms exiting the market. When mergers are being reviewed and when possible abuses of dominance cases are being assessed, the accent should be on protecting competition rather than competitors. Modern competition policy focuses on efficiency and protecting consumers; any other approach may lead to competition policy being reduced to an industrial policy that may fail to deliver long-term benefits to consumers.

e) Enterprise development

FDI *has the potential significantly to spur enterprise development in host countries. The direct impact on the targeted enterprise includes the achievement of synergies within the acquiring* MNE*, efforts to raise efficiency and reduce costs in the targeted enterprise, and the development of new activities. In addition, efficiency gains may occur in unrelated enterprises through demonstration effects and other spillovers akin to those that lead to technology and human capital spillovers. Available evidence points to a significant improvement in economic efficiency in enterprises acquired by* MNEs*, albeit to degrees that vary by country and sector. The strongest evidence of improvement is found in industries with economies of scale. Here, the submersion of an individual enterprise into a larger corporate entity generally gives rise to important efficiency gains.*

Takeovers generally lead to beneficial upgrades of governance and management, whereby a balance between foreign and domestic competences must be struck.

Foreign-orchestrated takeovers lead to changes in management and corporate governance. MNEs generally 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. Insofar as foreign corporate practices are superior to the ones prevailing in the host economy, this may boost corporate efficiency, empirical studies have found. However, to the extent that country-specific competences are an asset for managers in subsidiaries, MNEs need to strive toward an optimal mix of local and foreign management.

The experiences with foreign participation in privatisations have been positive, although measures to boost efficiencies have sometimes been politically controversial.

An important special case relates to foreign participation in the privatisation of government-owned enterprises. 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 near-term job losses. Moreover, the value of FDI in connection with privatisation in transition economies could partly 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 resulted.

The privatisation of utilities in developing countries has sometimes given rise to problems with safeguarding competition.

The privatisation of utilities is often particularly sensitive, as these enterprises often enjoy monopolistic market power, at least within segments of the local economy. The first-best privatisation strategy is arguably 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.

Authorities have incentives to use FDI as a tool in their strategies toward enterprise development and restructuring.

Overall, the picture of the effects of FDI on enterprise restructuring that we can derive from recent experience may be too positive, because investors will have picked their targets among enterprises with a potential for achieving efficiency gains. However, from a policy perspective, this makes little difference, as long as foreign investors differ from domestic investors in their ability or willingness to improve efficiency or realise new business opportunities. Authorities aiming to improve the economic efficiency of their domestic business sectors have incentives to encourage FDI as a vehicle for enterprise restructuring.

III. FDI and environmental and social concerns

FDI *has the potential to bring social and environmental benefits to host economies through the dissemination of good practices and technologies within* MNEs*, and through their subsequent spillovers to domestic enterprises. There is a risk, however, that foreign-owned enterprises could use* FDI *to "export" production no longer approved in their home countries. In this case, and especially where host-country authorities are keen to attract* FDI*, there would be a risk of a lowering or a freezing of regulatory standards. In fact, there is little empirical evidence to support the risk scenario.*

While responsibility rests largely with the host-country authorities, FDI has a strong potential to benefit the environment…

The direct environmental impact of FDI is generally positive, at least where host-country environmental policies are adequate. There are, however, examples to the contrary, especially in particular industries and sectors. Most importantly, 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.

… since MNEs generally possess "cleaner" and more modern technologies.

The technologies that are transferred to developing countries in connection with foreign direct investment tend to be more modern, and environmentally "cleaner", than what is locally available. Moreover, positive externalities have been observed where local imitation, employment turnover and supply-chain requirements led to more general environmental improvements in the host economy. There have been some instances, however, of MNEs moving equipment deemed environmentally unsuitable in the home country to their affiliates in developing countries.

The use of such inferior technology will usually not be in the better interest of a company; this demonstrates the sort of environmental risk associated with FDI.

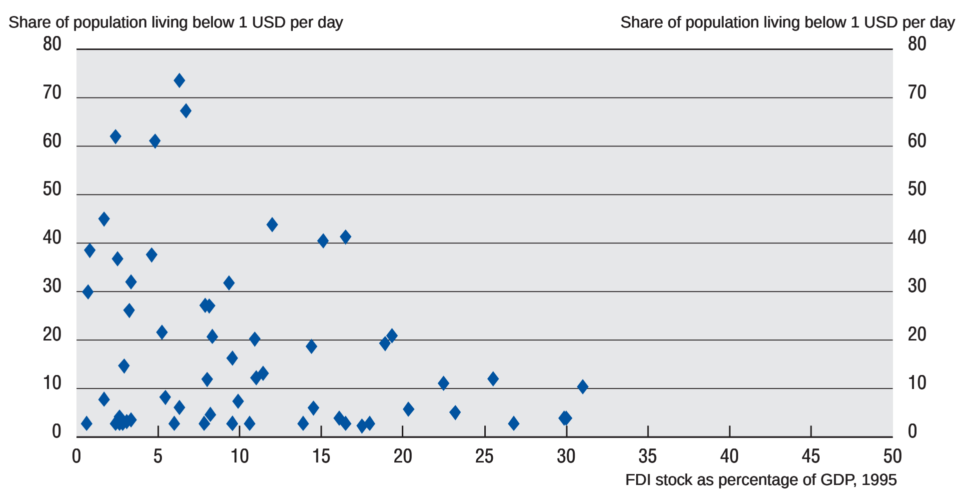
There is little evidence of MNEs inducing host countries to loosen their environmental standards.

Empirical studies have found little support for the assertion that policy makers' efforts to attract FDI may lead to "pollution havens" or a "race to the bottom". The possibility of a "regulatory chill", however, is harder to refute for the lack of a counterfactual scenario. 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. The evidence supporting this argument seems to depend on the wealth and the degree of environmental concern in the MNEs' other countries of operation.

FDI may help address social concerns by acting as a tool to alleviate poverty...

Empirical evidence of the social consequences of FDI is far from abundant. Overall, however, it supports the notion that foreign investment may help reduce poverty and improve social conditions (see also Figure 3). The general

Figure 3. **Poverty and inward FDI stock (in 60 developing countries)**



Source: World Development Indications.

effects of FDI on growth are essential. Studies have found that 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.

… especially as most MNEs take an interest in furthering social cohesion and labour standards. There are, however, some examples, in specific countries and sectors, of the opposite effect.

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. Problems may, however, arise in specific contexts. For example, the non-trivial role that EPZs play in many developing countries could, some have argued, raise concerns regarding the respect for basic social values.

IV. Conclusion: benefits and costs

The main policy conclusion that can be drawn from the study is that the economic benefits of FDI are real, but they do not accrue automatically. To reap the maximum benefits from foreign corporate presence a healthy enabling environment for business is paramount, which encourages domestic as well as foreign investment, provides incentives for innovation and improvements of skills and contributes to a competitive corporate climate.

The magnitude of the benefits from FDI depends on the efforts of host countries to put in place the appropriate frameworks…

The net benefits from FDI do not accrue automatically, and their magnitude differs according to host country and context. The factors that hold back the full benefits of FDI in some developing countries include the level of general education and health, the technological level of host-country enterprises, insufficient openness to trade, weak competition and inadequate regulatory frameworks. Conversely, a level of technological, educational and infrastructure achievement in a developing country does, other things being equal, equip it better to benefit from a foreign presence in its markets.

... but even less-well performing countries may benefit,* inter alia *by using FD as a supplement to scarce financial resources.

Yet even countries at levels of economic development that do not lend themselves to positive externalities from foreign presence may benefit from inward FDI through the limited access to international funding. By easing financial restraint, FDI enables host countries to achieve the higher growth rates that generally emanate from a faster pace of gross fixed capital formation. The eventual economic effect of FDI on economies with little other recourse to finance depends crucially on the policies pursued by host-country authorities. The sectoral composition of an economy can also make a difference. While the service sectors of many developing countries may be underdeveloped and hence unable to attract large inflows of FDI, extractive industries in countries with abundant natural resources can be developed beneficially with the aid of foreign investors.

FDI-induced economic change may produce some adverse distributional and employment effects in the host country. Both categories of problems should be temporary, but they can be prolonged and aggravated in the absence of appropriate policy responses.

In addition to the potential drawbacks of inward FDI mentioned earlier, some micro-oriented problems could arise. For instance, while the overall impact of FDI on enterprise development and productivity is almost always positive, it generally also brings distributional changes and a need for industrial restructuring in the host economy. Changes give rise to adjustment costs and are resisted by social groups that do not expect to be among the beneficiaries. Structural rigidities in the host economy exacerbate such costs, not least where labour markets are too slow to provide new opportunities for individuals touched by restructuring. Overall, the costs are best mitigated when appropriate practices are pursued toward flexibility, coupled with macroeconomic stability and the implementation of adequate legal and regulatory frameworks. While the responsibility for this lies largely with host-country authorities, home countries, MNEs and international forums also have important roles to play.

FDI tends to act as a catalyst for underlying strengths and weaknesses in the host economy, bringing to the fore both its advantages and its problems.

In cases where domestic legal, competition and environmental frameworks are weak or weakly enforced, the presence of financially strong foreign enterprises may not be sufficient to assist economic development – although there are examples (notably in finance) where the entry of MNEs based in OECD member countries has contributed to an upgrading of industry standards. Where economic and legal structures create a healthy environment for business, the entry of strong foreign corporate contenders tends to stimulate the host-country business sector, whether through competition, vertical linkages or demonstration effects. FDI can be said to act as a catalyst for underlying strengths and weaknesses in the host countries' corporate environments, possibly exacerbating the problems in "non-governance zones", while eliciting the advantages in countries with a more benign business climate and better governance. This reinforces the point made above about the need for host (and home) countries to work to improve regulatory and legal frameworks and other elements that help enable the business sector.

Countries generally should not base their development strategies on the benefits of FDI. Inward FDI should be seen as a valuable supplement to local efforts rather than as a main source of growth.

Finally, FDI – like official development aid – cannot be the main source for solving poor countries' development problems. With average inward FDI stocks representing around 15 % of gross domestic capital formation in developing countries, foreign investment acts as a valuable supplement to domestically provided fixed capital rather than a primary source of finance. Countries incapable of raising funds for investment locally are unlikely beneficiaries of FDI. Likewise, while FDI may contribute significantly to human capital formation, the transfer of state-of-the-art technologies, enterprise restructuring and increased competition, it is the host country authorities that must undertake basic efforts to raise education levels, invest in infrastructure and improve the health of domestic business sectors. Domestic subsidiaries of MNEs have the potential to supplement such efforts, and foreign or international agencies may assist, for example through measures to build capacity. But the benign effects of FDI remain contingent upon timely and appropriate policy action by the relevant national authorities.

V. Policy recommendations

Policies matter for reaping the full benefits of FDI. Foreign investors are influenced by three broad groups of factors: the expected profitability of individual projects; the ease with which subsidiaries' operations in a given country can be integrated in the investor's global strategies; and the overall quality of the host country's enabling environment. Some important parameters that may limit expected profitability (e.g. local market size and geographical location) are largely outside the influence of policy makers. Moreover, in many cases the profitability of individual investment projects in developing countries may be at least as high as elsewhere. Conversely, developed economies retain clear advantages in the second and third factors mentioned above, which should induce less advanced economies to undertake policy action to catch up. Important factors such as the host country's infrastructure, its integration into the world trade systems and the availability of relevant national competences are all priority areas.

a) The challenges facing host country authorities

Sound FDI policies and policies toward domestic enterprise development are largely equivalent.

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. As stated in the Monterrey Declaration, domestic resources in most cases provide the foundation for self-sustaining development. An enabling domestic business environment is vital not only to mobilise domestic resources but to attract and effectively use international investment.

They fall into three categories, namely…

As the experience of OECD members and other countries has shown, the measures available to host-country authorities fall into three categories: improvements of the general macroeconomic and institutional frameworks; creation of a regulatory environment that is conducive to inward FDI; and upgrading of infrastructure, technology and human competences to the level where the full potential benefits of foreign corporate presence can be realised.

… macroeconomic stability and quality of financial intermediation,

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 (and while macroeconomic and financial enabling environments have not been the focus of the main report), 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. A priority area is the development of capital markets and financial instruments to promote savings and provide long-term credit efficiently. This will help alleviate funding constraints in general and allow local enterprise development to benefit those business opportunities arising from foreign corporate activities. This process will entail a progressive implementation of multilaterally agreed financial standards.

… an improved enabling environment,

The broader enabling environment for FDI is generally 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. Moreover, a lack of transparency may lead to illicit and other unethical practices, which generally weaken the host country's business environment (Box 2). In this context, host-country authorities should undertake the following measures:

- Strengthen their efforts to consolidate the rule of law and good governance, including by stepping up efforts against corruption and enhancing policy and regulatory frameworks (*e.g.* as regards competition,

Box 2. Host-country transparency

Among the elements of the enabling environment that can be influenced by policies, transparency is arguably the most important. Case studies suggest that companies may, for example, be willing to invest in countries with legal and regulatory frameworks that would not otherwise be considered as "investor friendly", provided they are able to obtain reasonable clarity about the environment in which they will be operating. Conversely, there appear to be certain threshold levels for transparency beneath which business conditions become so opaque that virtually no investor is willing to enter, regardless of the inducements. Another important factor related to transparency is the degree of social cohesion and stability of the host country. The absence of cohesion and stability greatly adds to investors' risk perception, and may spark concerns among foreign enterprises about possible damage to their reputations.

The need for transparency relates both to the actions taken by authorities and to the broader business environment of the host country. Given the relative irreversibility of FDI, uncertainties about legislative action and rules enforcement act as major impediments, giving rise to risk premiums and raising fears of discriminatory treatment. A non-transparent host-country business environment raises information costs, diverts corporate energies toward rent-seeking activities, and may give rise to outright crime such as corruption. While this weighs on the host-country business sector, it arguably acts as an even greater discouragement to outsiders, who are not privy to locally available information.

The costs to host-country authorities and enterprises of achieving a high level of transparency, while nontrivial, must be contrasted with the considerable costs to both domestic and foreign investment of maintaining a non-transparent national business environment. Home-country institutions and international organisations may assist host-country authorities through measures toward capacity building.

FDI often contributes to creating a more transparent environment. There are cases of foreign corporate presences encouraging more open government practices, raising corporate transparency and assisting in the fight against corruption. More generally, by inducing MNEs to observe commonly agreed standards such as the OECD Convention on Combating Bribery of Foreign Public Officials, the Declaration on International Investment, and the Guidelines for Multinational Enterprises, home-country authorities can contribute to raising standards for corporate social responsibility in host countries.

financial reporting and intellectual property protection) to foster a dynamic and well-functioning business sector. Such policies will benefit the climate for FDI through their effect on transparency. By bringing a larger share of the informal economy into the open, they will also have important secondary effects on countries' ability to attract investment.

- Work toward increased openness to foreign trade, so the domestic enterprise sector can participate fully in the global economy. This approach should be undertaken jointly with efforts to increase business-sector competition. A combined approach would allow a greater domestic and international openness to business to go hand-in-hand with safeguards against the negative effects of a rise in concentration. Moreover, 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, and that incumbent enterprises are not unduly disadvantaged *vis-à-vis* foreign-owned ones.

... and an upgrading of the relevant infrastructure.

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 – undertake 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. Allowing foreign investment in infrastructure sectors and leveraging such investment by means of ODA may assist in these efforts.

- 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. A healthy workforce population is also needed, which requires basic public health infrastructure (*e.g.* clean water).
- Implement internationally agreed. 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. Additionally, a comparatively sound environmental and social framework becomes increasingly important for countries seeking to attract international investments operating on high standards.
- Consider carefully the effects of imposing performance requirements on foreign investors. Rather than justifying performance requirements as a necessary counterweight to generous FDI incentives, countries may wish to reassess the incentive schemes themselves. Moreover, it should be recognised that such requirements may work against efforts to attract higher quality FDI.

b) The challenges facing home-country authorities

Home-country authorities may assist the efforts of host countries, for example by…

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 – should review the ways in which their national policies affect developing countries. Thus, the benefits of FDI that flow from increased international trade integration and diffusion of technology, as mentioned in this report, are influenced significantly by the policies of developed countries.

... liberalising their foreign trade regimes,

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 magnitude of which arguably exceeds aid flows). 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.

... encouraging technology transfers to developing countries,

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".* The need for home-country governments to play a role with respect to least developed countries is highlighted by Article 66(2) of the TRIPS Agreement, which states that:

"Developed country members shall provide incentives to enterprises and institutions in the territories for the purpose of promoting and encouraging technology transfer to least-developed country members in order to enable them to create a sound and viable technological base".

* The OECD Declaration and Decisions on International Investment and Multinational Enterprises, Annex I, Section VII.2.

... reviewing their own policies for attracting FDI,

While recognising that developed and developing countries generally do not compete for the same investment projects, developed countries should remain attentive to the potential impacts of their measures of subsidising inward direct investment on developing countries' ability to attract FDI.

... and exploiting the synergies between FDI and official development assistance.

Another area of action relates to improving the synergies between FDI flows and ODA. While ODA has been, in certain least-developed countries, the only substitute for inadequate FDI, there is evidence 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. Some donor and recipient countries are already working along these lines. ODA funds can be used to support those areas considered important to investors in determining investment decisions, notably by helping host countries achieve some of the measures outlined in the previous section. Efforts to improve physical infrastructure, human capital and health in developing countries are all cases in point. Moreover, through its effect on social cohesion, ODA may help make developing countries more attractive locations for FDI.

c) The role of multinational enterprises

MNEs also have responsibilities...

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.

... as stipulated, for example, by 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 36 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.

... and by codes of conduct drawn up by the enterprises themselves.

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. The Guidelines can be used by governments, business associations and other stakeholders to support these initiatives and enlist a larger number of companies in the search for best development practices.

d) *The importance of international co-operation*

International co-operation remains vital...

International co-operation, whether under the auspices of international organisations or bilaterally, may assist and reinforce the FDI-related efforts of host countries, home countries and multinational enterprises (a point touched upon in the previous section). The added value of co-operation in the context of home countries, or developed countries more broadly, lies in the fact that the fields for policy action suggested above cannot easily be pursued by countries acting alone. Embarking on the vast array of policy measures proposed above for host countries is beyond the capabilities of many poorer nations. This creates a scope for other countries and organisations to help via measures aimed at technical assistance and capacity building.

... not least in areas such as investment capacity building.

Against the background of the Doha and Monterrey Declarations, which identify capacity building as a priority area for international co-operation, international organisations and relevant national agencies should carefully assess the need for activities in the field of international investment – particularly FDI. Increased capacity-building measures would focus on assisting developing countries to develop stronger competences in the following fields: general supply-side challenges; formulation and implementation of broad-based policies toward FDI; and the specific architecture for negotiating and implementing international treaties and agreements related to foreign investment.

The OECD is well placed to contribute to these efforts...

The OECD has a key responsibility to act as a forum for sharing Members' experience with capacity building and with investment instruments of co-operation. The OECD's distinctive methodology relies on a peer-review process based on long-tested benchmarking for FDI policies, recommendations from governments with diverse perspectives and cultures, and the monitoring of process.

... which must be undertaken by several international organisations in concert.

The success of such an approach will depend on the mechanisms for co-ordinating the use of resources for capacity building and technical assistance. The challenges are so great that no single institution can respond adequately to the needs of developing countries. This implies a need for greater co-operation among investment and aid agencies, and for institutional support to field representatives of aid agencies to engage in a broader range of investment capacity-building activities. Such enhanced responses presuppose that international organisations give investment capacity building a very high priority at both headquarters and the field level.

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