Foreign Direct Investment for Development?

David Woodward

FDI flows to developing countries have grown strongly in recent years, more than reversing the post-2001 decline. Total flows in 2006 were nearly double their 2001 level, and are estimated to have increased by a further 20% in 2007. Around 30% of flows to developing countries in 2005-6 took the form of mergers and acquisitions (M&As). Total flows were 13.8% of gross fixed capital formation in 2006; and inward FDI stocks have increased from 9.6% of GDP in 1990 to 26.7% in 2006.

While flows to West Asia have increased by 700%, those to Latin America remain marginally above the 2001 level. Extractive sectors predominate in Sub-Saharan Africa (SSA), and services in West Asia, while knowledge-intensive sectors have become more important in East Asia. The numbers of international investment agreements, and of changes in policies towards FDI, remain high; and 80% of policy changes are favourable to investors.

The Monterrey Consensus

The Monterrey Consensus places great emphasis on increasing FDI flows to developing countries, with little differentiation among investments, host countries, or the characteristics of FDI. In principle, benefits from FDI to the host country can emanate from

(1) increases in employment,
(2) technological spill-overs,
(3) higher public revenue and
(4) a positive impact on growth.

However, such benefits may be off-set by negative long-term balance-of-payments effects if outflows for profit remittances and imports outweigh the initial capital inflow and additional export revenues.

Evidence on all these counts is mixed, essentially indicating that FDI impact on both growth and development varies considerably. With regard to (1), inward FDI stocks per job in foreign-owned enterprises (FOEs) range from $1,000 to $250,000, and indirect job creation through backward linkages may be off-set by the displacement of local competitors in non-tradeable sectors. Technological spill-overs do not manifest in the same sector, although there is potential for FOEs to foster technological advancement among suppliers. (3) can be substantial, but may be off-set by tax reductions/concessions to attract FDI and/or revenue losses from the displacement of competitors. Finally, if FDI services the domestic market, no export revenues will ease the strain on the current account.

Taking account of the weak impact of FDI, it is necessary to qualify potential projects regarding

(1) the ***type of FDI***, i.e., which sector it occurs in,
(2) the ***mode of FDI***, i.e., greenfield- vs. M&A activity,
(3) the ***host country of FDI***, i.e., structural as well as regulatory characteristics.

Green-field investment in *manufacturing*, particularly for export, is potentially beneficial, creating significant employment, limited substitution for local production, and substantial opportunities for backward linkages. However, the share of manufacturing in FDI has declined dramatically in recent years, as the share of services in the global stock of FDI has grown from 25% in the early 1970s to 60% in 2002.

The very diverse nature of the *services* sector makes generalization particularly difficult. Apart from export-oriented cross-border services (e.g. call centres), however, services FDI is generally dominated by M&As geared to serve the domestic market. It therefore substitutes domestic supply, and does not produce foreign exchange earnings, with the concomitant adverse effects on the balance of payments. Certain sub-sectors may allow technology transfers with economy-wide benefits, e.g. telecommunications and business services. FDI in services may also give rise to systemic risk due to inadequate regulatory capacity, structural risk following privatization of state-owned enterprises and contingent risk due to impact in socially or culturally sensitive areas.

In *primary sectors*, potential benefits are greatly reduced by limited direct employment creation, backward linkages and potential for technology transfer. Public revenue benefits from royalties are very variable (25-90% of total revenues in oil and gas, and 25-60% for metals), and likely to be lowest in the poorest countries, where bargaining power is weakest. Revenues must also

be set against environmental costs, accelerated depletion of natural resources and the opportunity cost of their future development. In aggregate, the price effects of increased production may outweigh the benefits.

FDI through *M&As* is generally less beneficial than green-field investment, as productive capacity is not directly increased; and indirect long-term benefits may be off-set by reduced backward linkages and/or negative balance of payments effects. M&As represent two-thirds of total FDI globally, and around one-third in developing countries.

FOEs' integration into the domestic economy may be greater in *joint ventures*, pre-existing companies bought by foreign investors, and where senior management positions are occupied by host country nationals. Employment of nationals in senior technical positions may contribute to technology transfer over the longer term. Conversely, stronger integration with the *parent company* may have negative effects, by increasing opportunities for transfer price manipulation[1].

FDI inflows depend heavily on *host country characteristics*, particularly market size, infrastructure, as well as political and economic stability.

Such non-policy factors attracting FDI are desirable irrespective of their implications for inflows, but less susceptible to direct policy control, resulting in a focus on deregulatory and tax measures aimed at foreign investors or the corporate sector as a whole.

Positive growth effects of FDI require a minimum threshold level of human capital[i], in order to allow for employment in senior positions, creating potential for technology diffusion. Positive effects also depend on a sufficiently developed financial system[ii], found to exist in only 37 countries (mostly in Asia and Latin America) in a sample of 67[iii]. The impact of the business climate, labour costs and openness are not conclusive[iv], and neither are those on policies directly relating to FDI: effects of free trade zones are positive, but those of fiscal incentives variable[v].

Where economic conditions are not conducive to FDI, flows will be lower, rates of return and policy concessions required to attract investment higher, and developmental benefits commensurately smaller. Overall, both the conditions which attract FDI, and those conducive to positive developmental effects, indicate much more favourable effects in middle-income than in low-income countries.

Conclusions

A clear distinction needs to be made between maximizing FDI flows and maximizing their contribution to development.This suggests a need for a much more differentiated consideration of FDI, both among productive sectors and between M&As and green-field investment; and for much greater attention to complementary policies to maximize the developmental benefits of FDI. In both cases, it is also necessary to differentiate among host countries, in terms of their levels of development, absorption capacity and factor endowments.

In the short and medium term, some policy measures to increase the development impact are likely to reduce aggregate flows, although the potential for accelerated development may allow greater synergy between the interests of investors and those of the populations of developing countries in the long term.

Internationally, key objectives include the preservation of policy space for governments to pursue appropriate policies to maximize the developmental benefits of FDI, including

(1) mechanisms to reduce tax competition and ease constraints on regulatory measures to improve the development impact of FDI;
(2) mechanisms to control transfer price manipulation;
(3) requirement of comprehensive disclosure of ownership of FOEs;
(4) mechanisms to ensure greater transparency in contractual terms for investment in extractive industries; and
(5) avoidance of new and review of existing international agreements and other instruments which undermine these objectives.

Nationally, variations in country circumstances render generalization about specific policies impossible, and some measures may be dependent upon measures at the international level. However, central *objectives* of national policies should include:

(1) ensuring that the form, nature and sectoral composition of FDI optimize its development benefits, as part of a coherent industrial policy;
(2) maximizing backward linkages of FOEs with the domestic economy;

[1] Transfer price manipulation refers to a situation in which one company exports goods to another part of the same company in a different company, and uses its control of both sides of the transaction to set an artificially high or low price so as to transfer profits between jurisdictions, eg to reduce its overall tax liabilities.

(3) increasing absorptive capacity, particularly for technology transfer, by improving education;
(4) maximizing the contribution of FOEs to public revenue, by rigorous application of appropriate taxes, minimizing tax concessions and subsidies, and preventing transfer price manipulation;
(5) effective competition policies to prevent market dominance by FOEs;
(6) raising and enforcing applicable environmental and social standards, including health and safety provisions.

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David Woodward is an independent development consultant based in Europe. Professor of Economics, Institute of Economics, Federal University of Rio de Janeiro, Brazil.

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[v] Lim (2001) *loc. cit.*