



Financing for Development Series: Foreign Direct Investment – A Means to Foster Sustainable Development?

Foreign direct investment (FDI) represents an increasingly important source of external finance for developing countries. However, its developmental effects are still debated. This paper provides an overview of the possible effects of FDI and stresses the importance of host country characteristics and the type of FDI for a beneficial impact to the host country. Potential benefits from FDI include its contribution to increasing the domestic capital stock, creating employment and raising incomes, and promoting technology and skill transfer. Yet FDI may also lack positive impacts or even carry negative consequences, such as crowding out local firms, reinforcing domestic inequalities, or contributing to an outflow of foreign exchange.

Rather than attracting as much FDI as possible host country governments would be well advised to focus their efforts in inviting the “right” kind of FDI. Most importantly, foreign investments should be well-integrated into the local economy. The international community should work to strengthen the capacity of host countries to enact policies which facilitate a beneficial economic impact of multinational enterprises.

In light of these challenges and the unequal global distribution of FDI, increasing private investment alone cannot be considered a cure for poverty in the world’s least favored economies in the foreseeable future.

1. Relevance of foreign direct investment

In recent years worldwide inflows of foreign direct investment (FDI) have risen substantially. Since 1980, the inward stock of FDI of developing countries has expanded from 10 % of their GDP to about one third, today representing their largest source of external funding.

As a new phenomenon, emerging economies like China are gaining importance not only as FDI recipients but also as outward investors: South-South FDI flows represented 17 % of global FDI flows in 2005. While Chinese investment in Africa has received considerable attention, other emerging and middle income countries like South Korea, Brazil, and South Africa have also become important outward investors in developing countries.

Many governments and international organizations consider FDI to have largely positive impacts on host countries. The outcome document of the International Conference on Financing for Development in Monterrey in 2002 also displays this view, claiming that “foreign direct investment contributes toward financing sustained economic growth over the long term”. The draft outcome document for the 2008 Doha conference largely reaffirms this positive assessment of FDI’s development contribution. Yet empirical work examining the impact of FDI on development has provided a more mixed assessment of its effects, suggesting that FDI may be overrated as a development finance instrument.

This paper reviews the reasons why FDI may have a beneficial or detrimental development impact, and outlines

some recommendations on how governments and the international community can help to ensure that positive development effects of FDI can be realized.

2. Potential development benefits of FDI

Rise in capital stock

Economic growth depends, inter alia, on investment which requires capital. FDI generates a capital inflow for the host country and thus increases the domestic capital stock. In economies where capital is scarce this facili-

Box 1: Foreign direct investment – definitions

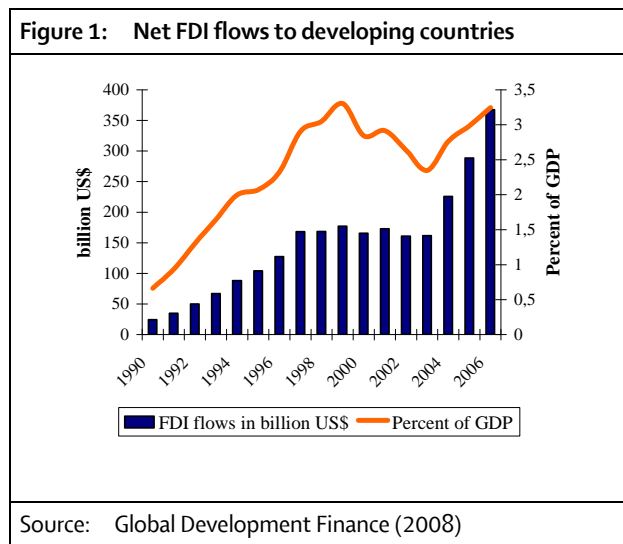
FDI are investments undertaken by a resident enterprise of one economy in a resident enterprise of another economy with the objective of establishing a lasting interest in the foreign entity, provided that the investor acquires a minimum of 10 % of the ownership rights. FDI occurs in different forms, namely in form of a *Greenfield Investment* (the establishment of a new production, distribution or other facility by the investing firm), as a *Merger or Acquisition (M&A)* with/of an existing company in the host country, or through a *Joint Venture* – a partnership between a host country firm or government institution and a foreign firm. FDI can be considered *market-seeking* if the firm wants to gain access to a local market, *resource-seeking* when securing access to specific and often scarce resources is desired, *efficiency-seeking* when economies of scale or scope are sought, or *strategic asset-seeking* when investment is a means of acquiring specific assets (e.g., know-how or brands) from other firms, or there are other strategic reasons. These varied types of FDI may differ substantially in their development impact.

Source: OECD (1999)

tates investments which would otherwise not take place.

Income and employment effects

FDI is assumed to create new jobs and thus income for the employees of foreign firms. This effect may be stronger for *Greenfield* investments in labor-intensive industries, while capital-intensive investments (e.g. the exploitation of natural resources) or the acquisition of an already existing firm may have a smaller or even a negative employment effect.



Tax revenue

Foreign enterprises are assumed to increase public revenue via direct and indirect taxes. The incomes of their employees will be taxed as well. This effect may be counteracted by efforts to attract FDI (e.g. tax holidays).

Managerial and technological spillover effects

Multinational firms tend to employ superior technology and know-how than is available locally in less developed countries. Spillovers to local industry may take place via trainings to the MNEs' (multinational enterprises) staff, which may later move on to local firms or set up their own business. Further spillovers are generated by demonstration effects (of efficient production and business techniques). As one of the most frequently mentioned (and controversially discussed) contributions of FDI, the named spillover effects can stimulate technological progress in the host country.

Competition effect

Domestic firms may be forced to improve the quality of their products if they are confronted with a foreign competitor in order to survive in their home market. This may improve the competitiveness of local goods on international markets and eventually facilitate exports of these goods. Evidently, a necessary condition for this effect is that domestic firms are not driven out of the market due to the MNEs' competitive advantage before they are able to catch up with them.

Backward linkages

MNEs often provide trainings to their local suppliers in order to guarantee sufficient quality of their inputs, thus also introducing higher international production standards. This strengthens the supplying firms, their productivity and the overall competitiveness of the industry. By sourcing inputs or services from local suppliers, the MNE is further embedded into the domestic economy, generating additional impact through increased local demand.

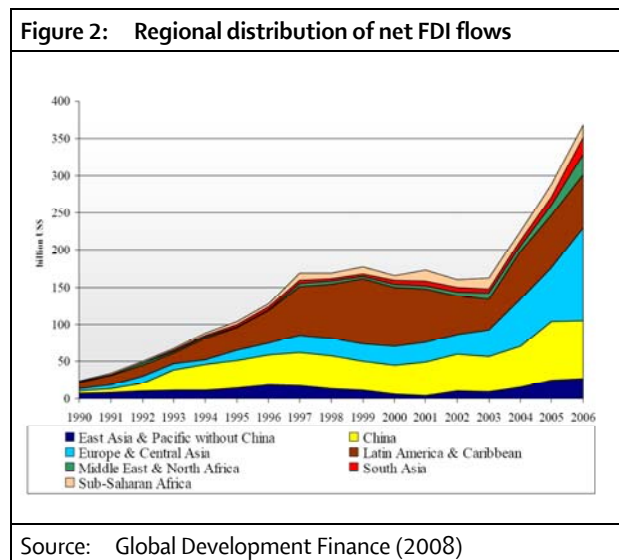
Infrastructure Development

MNEs often need to build up infrastructure to connect their firm to a transportation network or improve power supply capacities. A number of direct investments also occur directly in the infrastructure sector, such as railways, ports or power systems.

Multiplier effects

As outlined above, the hiring of local workers generates extra income. A proportion of these earnings will be spent on local goods and services and thereby increases the incomes of local producers, who in turn spend a part of their earnings in the domestic economy. Thus, the initial rise in incomes can further increase domestic income by raising domestic demand. The multiplier effect also applies to purchases of local supplies and to taxes paid by the MNE.

Foreign direct investment differs substantially from other kinds of capital inflows in that it comes as a "package", usually entailing superior technology and a higher degree of commitment to the host economy. Due to its long-term nature, FDI is less likely to be withdrawn in the event of short-term financial crises. In addition to direct effects such as the rise in capital, income and employment, indirect effects (in particular spillover and multiplier effects) may trigger enhanced domestic growth.



3. Potential development drawbacks of FDI

At the same time, FDI can have a number of problematic impacts:

Crowding out

Local businesses may be driven out of the market as foreign firms tend to operate more efficiently and have better access to capital, thus lowering their production costs.

Distributional consequences

Within a host economy, the concentration of FDI in particular sectors or in geographic regions that are attractive to investors can generate or reinforce income disparities. Wage differences between foreign and domestic firms may also increase inequalities.

Race to the bottom

Governments frequently offer incentives (e.g., tax holidays) to foreign firms in order to attract FDI, which decreases government revenue. Moreover, fierce competition for FDI among developing countries can lead to a "race to the bottom" of social and environmental standards.

Box 2: The distribution of FDI

While the volume of FDI to the developing world has expanded significantly in recent decades, these flows have not been evenly distributed. The world's Least Developed Countries (LDCs) continue to receive a miniscule amount of FDI: in 2007 their share of global FDI represented just 0.7 % of global flows. FDI has also been unevenly distributed across developing regions, with flows to East Asia and Latin America surpassing flows to South Asia and Africa by a wide margin.

The uneven distribution of FDI is also evident within the African continent. While the volume of investment in Africa rose to \$53 billion in 2007, recent increases have not changed Africa's status as a marginal destination for FDI (the continent's share of global FDI inflows hovered around 3 % in recent years). These inflows have been concentrated disproportionately in the continent's leading economies (Egypt, Nigeria, and South Africa) and in extractive industries.

The concentration of investment in extractive industries creates particular challenges for host countries. While intensified resource extraction can increase export earnings, a lack of economic diversification can be problematic because it can make resource-rich states vulnerable to fluctuations in commodities prices. Because of their limited employment-generation potential, the direct benefits from investments in the resource sector may also not be widely distributed. In addition, resource revenues can contribute to corruption or finance actions that are inconsistent with development goals, such as the purchase of arms.

Enhancing the positive developmental impact of FDI requires not only working to make a broader variety of countries attractive as investment destinations, but also efforts to encourage a diversification of investment in poorer countries. Strengthening the capacity of host country governments to develop policies that can mitigate the potential negative effects of FDI would also contribute to the goal of expanding FDI's development contribution.

Source: UNCTAD (2008)

Drain of foreign exchange

Both foreign sourcing or repatriation of profits by foreign firms may induce a net outflow of foreign exchange if production mainly serves the host country market. In this case the currency outflow cannot be off-

set by increasing export revenues, as in the case of export-oriented FDI.

Empirical evidence on FDI impacts is highly ambiguous. While some studies suggest a beneficial influence of FDI on growth, others state that this only holds for more advanced countries or cannot confirm a positive impact. Similar contradictions emerge when investigating the traceability of spillover effects. A great deal of these inconsistent results can be explained by the heterogeneity of both FDI and host country characteristics which does not allow "one size fits all"-answers and solutions. The actual impact of FDI depends on a multitude of variables, including the type and motivation of the investment as well as the attributes of the host country economy.

4. Importance of host country characteristics and the "right" kind of FDI

The kind of impact that FDI has on development prospects will be influenced by the nature of the environment that it is injected into. For example, few spillovers can be expected if the technology gap between the investing firm and the host country is too large, and if the level of education is below a certain threshold which hinders the adaptation and implementation of the new technologies.

A low level of law enforcement, missing political and institutional stability, corruption and poor infrastructure may not only dampen the growth-enhancing effects of FDI, but may also discourage foreign firms from making investments in the first place. On the other hand, a conducive business climate and a minimum of financial market development and trade openness have been proven to attract FDI to the host country and to generate economic benefits.

Although the motivations of firms to invest vary, a number of economic and political factors are commonly listed as determinants of FDI flows. Economic determinants of FDI include market size, the overall macroeconomic context (low inflation and exchange rate risk are preferable), the availability and quality of local factors of production (such as the skill-level of the work force), and the quality of local infrastructure. Political factors that may influence investment decisions include the stability of the political regime and the quality of the regulatory environment – in particular, excessive bureaucracy is frequently named as impediment. These factors can influence how much risk investors will expose themselves to and the types of operating constraints they will face. Policies that are designed to strengthen developing countries' performance on these economic and political fronts can therefore serve as a stimulus for investment and the further development benefits it may bring.

In addition to host country features, the characteristics of the attracted investment are also decisive for a host country to reap economic benefits from FDI. Investment should be embedded in the domestic economy, for example through local or regional sourcing and pro-

cessing networks in order to facilitate spillover and multiplier effects. Labor-intensive industries which create new local employment are desirable, in particular if qualified trainings to staff are provided. Export-intensive FDI enables better access to the global economy and generates foreign exchange revenues. An adequate level of technology is important to prevent a technological gap impeding spillovers. By this reasoning, the recent boost in South-South FDI may lead us to expect a higher development impact given more similar technology levels. Furthermore, since much of South-South FDI is intraregional, cultural proximity may allow for a better integration of the MNE into the local economy.

5. Conclusion – domestic policy space is key

Positive and growth-enhancing effects of FDI in a host country depend on a multitude of factors. The aim for a developing country is not simply to attract as much FDI as possible, but rather to focus on good-quality FDI enhancing the stated channels and impacts.

While the positive qualities of FDI may be in greater or lesser abundance depending on the practices of the firm making the investment, host country governments have an important role to play in ensuring that the development impact of FDI is benign. Public investment in education can, for example, increase the skill-level of the labour force and improve the prospects for private investment in the secondary and tertiary sectors. The presence of an adequate regulatory environment can not only reassure foreign investors but also contribute to the judicious management of the economic impact of multinational firms. Policies directed toward attracting the 'right kind of FDI' will also help to create framework conditions that are conducive to development.

Finally, it is critical that host countries have the capacity to enact the kind of policies that are most suitable to their investment environment. Due to treaty obligations, many developing countries do not have policy space to promote the positive impacts mentioned above. For some countries, local content requirements or performance requirements can be a promising means to promote positive spillover effects, and reasonable profit taxation will be advisable in most economies.

While FDI has been a great tool to help emerging economies like China develop and will continue to provide a wide array of potential benefits for internationally attractive countries, its capabilities to foster development in the world's least favoured countries are limited. A more equal global distribution of FDI, working for a reduction of poverty worldwide, is very unlikely to be

reached within the time frame of the Millennium Development Goals. In recent years South-South FDI flows have helped to channel increased FDI to less advanced economies. The challenge for the international community is not only to promote such FDI in marginalized regions, but also to support developing countries in implementing domestic policies that can foster FDI's positive development impact.



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