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Columbia FDI Perspectives
Perspectives on topical foreign direct investment issues by
the Vale Columbia Center on Sustainable International Investment
No. 98 July 1, 2013
Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)
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Do host countries really benefit from inward foreign direct investment?

by
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It was with great interest that we read *Perspective* No. 84 addressing the impact of inward foreign direct investment (IFDI) on technological innovation and entrepreneurship.[1] In that issue, Pathak, Laplume, and Xavier-Oliveira laid out arguments for and against IFDI. They suggested that we have, for far too long, extolled the benefits of IFDI for developing economies, without properly accounting for its costs. They noted that there are genuine concerns that we ought not to overlook, and that we should pay special attention to the impact of IFDI on local innovation and entrepreneurship. Understanding the relationship between IFDI and innovation is an important policy issue, as it can help inform whether, and how, IFDI can stimulate economic growth.

Central to addressing the debate regarding the effect of IFDI on local innovation is to determine whether foreign entrants enhance the innovativeness of local firms, or crowd out domestic innovation. One line of reasoning suggests that IFDI ought to lead to greater levels of local innovation as a result of knowledge spillovers to local firms. In addition, foreign entrants provide local firms an incentive to innovate as a means to compete, or in the case of vertical linkages, better to meet technical supply requirements.

Another line of reasoning casts doubt on the positive impact of IFDI, suggesting that foreign entrants relegate local firms to less innovative, less profitable market niches. Moreover, since foreign firms generally pay higher wages, foreign entrants might attract higher-skilled labor,

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[1] Saurav Pathak, André Laplume and Emanuel Xavier-Oliveira, "Inward foreign direct investment: Does it enable or constrain domestic technology entrepreneurship?," *Columbia FDI Perspectives,* No. 84 (December 3, 2012).

leaving domestic firms short on talent -- a key ingredient to innovation. Foreign entry can also reduce the expected returns to entrepreneurship, creating a situation in which the best would-be entrepreneurs prefer to take employment with foreign firms instead of founding new enterprises.

In order to address one aspect of this debate, we studied the effects of IFDI on productivity and innovation in the manufacturing sector of Spain from 1990 through 2002.[2] During that period, Spain received nearly € 45 billion of IFDI in manufacturing.[3] And though Spain is not a developing economy by traditional metrics, relative to its OECD counterparts, it is a laggard. Hence, Spain is considered a middle-income, developed country;[4] and given its position between developed and developing markets, Spain makes an interesting setting in which to test the relationship between IFDI and innovation.

Interestingly, as IFDI increased in specific industries, Spanish manufacturing firms improved their productivity (both total factor productivity and labor productivity). However, as IFDI rose in those same industries, Spanish firms subsequently applied for fewer patents and introduced fewer new products.

These findings highlight the importance of distinguishing between productivity and innovation when considering the net benefits of IFDI. Productivity and innovation might not capture the same outcomes, and may therefore speak to two very different aspects of the debate.

For example, productivity captures short-run improvements in allocative and technical efficiency. Therefore, to the extent that Spain lags the global technological frontier in high-tech manufacturing,[5] we may simply observe productivity increases as a result of a catch-up effect -- i.e., Spanish firms adopting the more efficient manufacturing techniques that entrants bring with them.

Innovation, by contrast, may be a better indicator of the long-run consequences for growth. To the extent that IFDI crowds out local innovation, it may fail to provide desired growth outcomes. IFDI may actually hinder the development of technological capabilities among local firms and, hence, the long-term growth prospects of local economies.[6]

Circling back to the issue of whether to encourage IFDI as a matter of policy, there is reason for pause. Our findings call into question whether IFDI can serve as a long-run growth catalyst, or whether it simply offers a short-term fix. Sure, IFDI may spur job creation, increase tax revenues and improve the productivity of local firms. Those outcomes benefit the host country and are welfare enhancing in the near term. However, as a consequence of IFDI, local innovation may become impaired, dampening long run economic growth, development and social welfare.

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[2] Francisco García, Byungchae Jin and Robert Salomon, "Does inward foreign direct investment improve the innovative performance of local firms?," *Research Policy*, vol. 42 (February 2013), pp. 231-244.

[3] OECD Statistics Database.

[4] Guillén Mauro. *The Rise of Spanish Multinationals: European Business in the Global Economy* (Cambridge: Cambridge University Press, 2005).

[5] Robert Salomon and Byungchae Jin, "Does knowledge spill to leaders or laggards? Exploring industry heterogeneity in learning by exporting," *Journal of International Business Studies*, vol. 39 (January 2008), pp. 131-150.

[6] García, Jin and Salomon, *op. cit*.

All things considered, there are potential tradeoffs between IFDI's near-term benefits and its long-run costs. This is not to say that IFDI should be discouraged. Rather, policies that subsidize foreign entry ought to be thought through carefully. Policymakers would be well served to pay special attention to tradeoffs, and enact policies that are consistent with long-term development objectives.[7]

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[7] John Kline, "Evaluate sustainable FDI to promote sustainable development," *Columbia FDI Perspectives,* No. 82 (November 5, 2012).