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REVIEW OF APPROACHES TOWARDS FDI: DRIVING FORCES AND PLAUSIBLE CONSEQUENCES

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Annotation. *The article analyzes the impact of FDI on economic growth and development of a host country in various conditions. Different sets of driving forces characteristic for certain stages of development of FDI receiving country are being considered. As the final aim of the critical analysis of contemporary theoretical and empiric findings the authors see the discovery of consistent patterns.*

Several FDI theories are reviewed in the article. The effects of FDI in developing countries are especially highlighted. The disparity between theoretical and empirical findings is taken into account: negative and positive aspects of FDI impact on countries that are on the path of development are revealed and interpreted.

The authors conclude that the nature of the effects of FDI is mainly determined by specific characteristics of the developing countries, such as market structure, level of capital attainability and its absorptive capacity and others. Together with the development of the recipient country, FDI driving forces and outcomes transform.

Keywords: *social science fields, management and administrative direction, foreign direct investments, FDI factors, FDI effects, transition countries.*

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Introduction

Over the past two decades the significance of foreign direct investment (hereinafter – FDI) and scientific investigation of FDI have increased. Interpretations of FDI involve such disciplines as international economics, economic geography, international business, and management. Because of the interdisciplinary nature of FDI, none of the above-mentioned disciplines can alone fully explain the phenomena of FDI.

The object of this article is critical evaluation and generalization of the economic effects, which FDI triggers in the recipient country. The authors consider the following aspects of FDI effects: capital provision, employment, innovation and technology, market structure, and production productivity. The research is based on theoretical speculations and empirical evidence provided by scientific literature on the subject.

1. Perception and Classification of FDI

In order to immerse into driving forces and consequences of FDI, one needs to have a clear idea of activities that complex phenomenon embrace. Hence, foreign investments are generally referred to investments made by individuals or enterprises that have their centre of economic interest in an economy other than the economy in which they invest. These international capital flows take two major forms: Foreign Direct Investments and Foreign Portfolio Investments[1]. Foreign Direct Investment is a flow of lending to or purchase of ownership in, a foreign enterprise that is largely owned by residents of the investing country. Direct investment implies long-term relationship between the direct investor and the enterprise, and a significant (full or partial) degree of control by the investor over the management of the enterprise and, usually, physical presence of foreign firms or individuals in the host country. Conventionally, FDI is established when a resident in one economy owns 10 per cent or more of the ordinary shares or voting power of an enterprise in the foreign country, unlike Foreign Portfolio Investment, which includes a variety of instruments traded in the organized financial markets.

Distribution of FDI sources and destinations is reflected by FDI flows and stocks. FDI flows, which may be inward and outward, consist of equity capital (the foreign investor's purchases of shares in an enterprise in a foreign country), reinvested earnings (share of earnings not distributed as dividends by affiliates or remitted to the home country, but rather reinvested in the host country) and intra-company loans comprising of short-term and long-term borrowings and lending of funds between the parent company and its affiliates). Another measurement, FDI stocks, represents the value of the share of the capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates of the parent enterprise. Like FDI flows, stocks can also be inward or outward.

1 Goldstein, I.; Assaf, R. An Information-Based Trade Off Between Foreign Direct Investment and Foreign Portfolio Investment. *Journal of International Economics*. 2006, (70): 271–295.

Different perspectives imply various classifications of FDI. From the perspective of the investing country, FDI can be classified into horizontal FDI, vertical FDI and conglomerate FDI[2] . Horizontal FDI occurs when corporations make "horizontal" investments to produce abroad the same lines of goods as they produce in the home market, thus exploiting their monopolistic or oligopolistic advantages. Vertical FDI occurs for the purpose of exploiting raw material or other input abroad to their production process at home (backward vertical FDI) or to be closer to the customers through acquisition of distribution outlets (forward vertical FDI). Conglomerate FDI includes both vertical and horizontal FDI. From the point of view of the host country, FDI can be import-substituting and export-increasing. Import-substituting FDI implies production of goods previously imported by the host country, resulting in imports by the host country to decline. Export-increasing FDI is undertaken seeking new sources of input, such as raw materials and intermediate products.

FDI can take three forms: Greenfield, mergers and acquisitions (M&A), and joint ventures[3]. Greenfield FDI is involved in establishing new production, distribution or other facilities in the host country. In the context of transition economies a term "Brownfield FDI" is often used to describe situation, when a foreign investor formally acquires a firm, but replaces almost completely resources and capabilities of the acquired firm[4]. FDI may occur through an acquisition of or a merger with an established firm in the host country. In case of transition economies M&A are often conditioned by the privatization processes. FDI can take form of joint ventures as well, either with a host country firm or a government institution, or with another company that is foreign to the host country[5].

2. Evolution of FDI Theories: Search for Driving Forces

Starting with heavy investments in the high-income counties, shifting to the South East Asia in the eighties and spreading to the previously centralized economies, mainly in the former Soviet block, FDI flows intensified in the 90s' and continued to grow over the current decade due to the rapid globalization processes[6]. In spite of the relatively short period, FDI has attracted many scholars and researchers in the field of economy, social sciences, etc. Substantial literature has been developed to explain the phenomenon of FDI, its motives, prerequisites and consequences. It should be noted, that due to the nature of the subject there is no general theory that would explain FDI phenomenon;

2 Caves, R. E. International Corporations: The Industrial Economics of Foreign Investment. *Economica*. 1971, 38(149): 1–27.

3 Raff, H.; Ryan, M.; Stähler, F. The Choice of Market Entry Mode: Greenfield Investment, M&A and Joint Venture. *International Review of Economics and Finance*. 2009, 18(1): 3–10.

4 Meyer, K.; Saul E. Brownfield Entry in Emerging Markets. *Journal of International Business Studies*. 2001, 32(3): 575–584.

5 Buckley, P. J.; Casson, M. Analyzing Foreign Market Entry Strategies: Extending the Internalization Approach. *Journal of International Business Studies*. 1998, 29(3): 539–561.

6 Miyake, M.; Sass, M. Recent Trends in Foreign Direct Investment. *Financial Market Trends* [interactive]. OECD, 2000 [accessed 2008-12-01]. <http://www.oecd.org/dataoecd/9/58/2090168.pdf>.

the interpretations of FDI span over several different disciplines including international economics, economic geography, international business and management. For expository purposes, the following section presents the evolution of FDI theory. Various FDI theories are discussed in turn as they evolved chronologically.

2.1 Neoclassical Theories

At the end of the 50's FDI has been prevailingly explained within the framework of neoclassical theories[7]. The neoclassical financial theory of portfolio flows based on differential interest rates was one of the first attempts to explain FDI flows. According to the theory, the capital move from countries where the interest rate is low to those where the interest rate is higher. The theory assumes risk neutrality and absence of barriers to movement of flows and transaction costs. These assumptions do not reflect reality, and when a more realistic version of the theory is used, i.e. risk and uncertainty and barriers to the movement of capital among nations are introduced, the theory loses its predictive ability. To incorporate risk and uncertainty in explanation of FDI, the portfolio diversification hypothesis was utilized. However, both the theory and hypothesis are criticized for the failure to realize the differences between portfolio and direct investment, and that that FDI is not only a capital flow but constitutes a package including other components such as management and technology transfer[8].

Neoclassical trade theory, which assumes that trade patterns are determined by relative supplies of factors of production (e.g. skilled and unskilled labour, capital and natural resources) and/or by differences in tastes and technology could not either explain why firms engage in intra-industry trade, or FDI, or why multinational companies exist[9].

2.2 Industrial Organization Theory

Important theoretical shortcomings of the neoclassical type trade and financial theory of portfolio flows were observed by Stephen Hymer. He made a thorough distinction between portfolio and direct foreign investment, which the traditional theory of investment based on differential interest rates, after accounting for the risk premium, could not explain. Hymer observed that FDI implies control of the operation while portfolio foreign investment implies a share of ownership, but not control. This observation prepared the ground for a separate theory of FDI formalized in his dissertation[10]. Thus Hymer analysed multinational enterprises (MNs) and FDI focusing on strategic beha-

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7 Buckley, P. J.; Hymer, S. Three Phases, One Approach? *International Business Review.* 2006, 15: 140–147.

8 Zebregs, H. Can the Neoclassical Model Explain the Distribution of Foreign Direct Investment across Developing Countries? *Working Paper No. 98* [interactive]. IMF, 1998, 139: 1-28 [accessed 2008-12-01]. <http://ssrn.com/abstract=882702>; Hosseini, H. An Economic Theory of FDI: a Behavioural Economics and Historical Approach. *The Journal of Socio-Economics*. 2005, 34: 528–541.

9 Scott, R. E. Flat Earth Economics: Is There a New International Trade Paradigm? *Challenge.* 1993, 36(5): 32–39.

10 Buckley, P. J.; Hymer, S.

viour of firms, the structure of markets and their interactions on the basis of industrial organization theory, the study of market imperfections. The theory was further extended by Kindleberger, and became known as Hymer–Kindleberger paradigm[11].

For Hymer, multinational enterprises (and therefore FDI) exist because of market imperfections. Viewing MNC as an institution for international production rather than international exchange, Hymer assumed that MNEs operate at a disadvantage with respect to the host country firms, since there additional costs exist of doing business abroad. Hymer asked the critical question of how a foreign company can compete successfully in an unfamiliar market, where it must be at a disadvantage compared to local firms. To him, in the face of these additional costs, for an MNE to own and control foreign value-adding activities and to be profitable, it must possess other advantages, some kind of innovatory, cost, financial or marketing advantages-specific to their ownership-which is sufficient to outweigh the disadvantages they face in competing with indigenous firms in the country of production. These advantages can take a form of larger or cheaper capital, intangible assets (trade names, patents, superior management), superior marketing techniques (entrepreneurial ability, market research, advertising, promotion), product diversification, superior technology (ability to translate scientific knowledge into commercial use), privileged access to raw materials, firm-level economies of scale. These advantages represent the barriers by which oligopolistic MNEs seek to close out market competition[12].

The dissertation of Stephen Hymer, which represents a breakthrough in explanation of FDI, was followed by a controversial Marxist-oriented work, where Hymer accuses FDI activities of MNEs for creating hierarchy, unequal distribution of benefits and uneven development between developed nations that control MNEs and subordinated host nations, most particularly the less – developed nations. Although Hymer acknowledges private welfare -increasing role of FDI, his conclusion on its impact on social welfare is negative. He even recommends the nations at risk of MNE domination to disengage from international trade and investment [13]

2.3 New Trade Theory

In response to inability of the traditional trade theory to incorporate intra-industry trade and FDI, the new trade theory analysing the effects of market imperfections on trade patterns provides explanations for international trade, where the same kinds of goods and services are both imported and exported, and for emergence of MNEs and FDI. According to Krugman, firms can take advantage of scale economies and of proprietary technology by seeking out global markets for their products. Firms based in one

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11 Hosseini, H.

12 Dunning, J. H.; Rugman, A. M. The Influence of Hymer Dissertation on the Theory of Foreign Direct Investment. *American Economic Review*. 1985, 75(2), 228-233.

13 McClintock, B. Recent Theories of Direct Foreign Investment: An Institutionalist Perspective. *Journal of Economic Issues*. 1988, 22(2): 477-485.

country may be able to dominate niches for their products, while firms in other countries will have advantages in other market niches[14].

Further developments of the new trade theory included explanation of decision of a firm between foreign production and exports. Consistent with the theory MNEs compare trade costs to the costs of producing at several locations on the basis of proximity-concentration trade-off, i.e. the advantage of producing in a single location to achieve scale economies is compared to the reduction in trade cost achieved when production takes place at several locations close to the local market. This resulted in distinction between two types of FDI-the horizontal FDI and vertical FDI, which strongly dominated trade theory models incorporating FDI. Horizontal FDI occurs when MNCs are seeking for new markets and wants to satisfy foreign market demand by local production. Horizontal FDI can necessitate adaptation of the product to the preferences of local customers. Higher trade costs in the form of tariffs tend to increase the incentive for horizontal FDI. The motives for vertical FDI is primarily an efficiency-seeking, i.e. the MNE exploits differences in factor costs between geographical locations, which can result in geographic decomposition of production process according to factor intensity. In particular, the labour-intensive stage of production is located where labour costs are low. Likewise, a capital-intensive stage is located where the cost of capital is low[15] [16].

2.4. The Kojima Hypothesis

The attempts to expand the analysis beyond the micro level of firm and market structure have been made by Japanese scientists Kojima and Ozawa. Opposing the international business approach their macroeconomic models combined micro variables such as relative factor endowments and intangible assets with macro variables such as government industrial and trade policies, to account for trends in a nation's dynamic comparative advantage. Viewed as a means of transferring capital, technology and managerial skills from the source country to the host, FDI is classified here in two kinds. The first is trade-oriented FDI, which generates an excess demand for imports and an excess supply of exports. Promoting trade and beneficial industrial restructuring, this kind leads to welfare improvement in both countries. The second kind is anti-trade-oriented FDI. This kind has adverse effects on trade, and it also promotes unfavourable restructuring in both countries[17]. To generalize, FDI has developed into the object for extensive theoretical elaborations and vast empirical studies for numerous researchers. Numerous theories and models have been drawn to explain the phenomenon of FDI and its motives as discussed above. Likewise, different approaches have been used to interpret the consequences of FDI movement with positive and negative impact identified. The fundamental disagreement on the cost and benefits is explained by the gap in opi-

14 Scott, R. E.

15 Markusen, J. R. Chapter 3: International Trade Theory and International Business. *Oxford Handbook of International Business*. 2001, p. 69–87.

16 Markusen, J. R.; Bora, B. Part II: Structural Issues Related to the Impact on FDI: DI and Trade. *Foreign Direct Investment*. 2002, p. 93–112.

17 McClintock, B.

nions between those holdings pro- globalization, free-market, views and those with anti-globalization, anti-market views, which is elaborated in the subsequent subsection.

3. Effects of FDI: Theoretical Speculations and Empirical Evidence

A great divergence exists in statements and comments on FDI among theorists of different schools of thought, between theorists and empirical analysts, and within the latter group. Being a matter of a great concern, effects of FDI remain a contentious issue. In order to comprehend the diversity of statements and the controversy around the issue, it is important to consider three main positions: proponents of political economics, proponents of purely market-economy, especially neoclassical school of economics, and less ideologically committed empirical researchers.

The denial of FDI as a factor having considerable impact on economic and social development is supported by the two main schools: the social anti-capitalistic (on the basis of Marxist theory) and the Dependencia School of Southern and Central America. According to Marxism and conceptually similar theories, capitalism and free markets denote the exploitation of one class of society by another class, which ultimately results in generation of alienated labour. Marxists argue that in order to enable the ruling class to turn a profit the capitalist system allows paying workers less than the full value of their labour, i.e. the profit gained by the private owners of means of production is the difference between the value of the product made by the worker and the actual wage received by that worker. In this manner, capitalist system functions because of expropriation of the surplus created by others. It is not rejected though that larger or smaller groups of employees draw economic benefits from the activities of the private enterprises, but this is interpreted as attempts to split the revolutionary working class by corruptive methods. This exploitation and alienation occur on the national and worldwide level, which fundamentally explains economic underdevelopment of the low- income countries. Consistent with the concept, Marxists reject private investments, including foreign investments, comparing them with "Trojan horses of western colonialism and imperialism against the Third World". The effects of such investments are therefore irrelevant as they are ultimately equated with exploitation[18].

Similarly to Marxism concepts, the views of Dependencia School disregard determination of actual attainable effects of FDI; these views emphasize existence of a dependent relationship, a situation in which a certain group of countries have their economy conditioned by the development and expansion of another economy, which leads to backwardness of the dependent countries and its perpetuation. Originated by the native Latin American scholars like Theotonio dos Santos and F. H. Cardoso and introduced through the works of A. Gunder Frank to the North America, these theories ascribed apparent difference in the development between the North and the South to the fact of

18 Kebschull, D. Effects of foreign direct investment in developing countries. *Intereconomics* [interactive]. 1980, 15(5): 235-240 [accessed 2008-12-01]. <http://www.springerlink.com/content/k354225k0273q852/>.

exploitation of the periphery of the world economy (the developing countries) by the politically and economically overpowering centre (the industrialized states). According to the proponents of Dependencia theories, in order to control and fully exploit power potential these centres have been building oligarchies in the developing countries. As a matter of concern, the FDI is obviously regarded as links between the centres of the world economy and its periphery. In line with this argument, the macro- and micro-economic effects of the investments do not matter. Some effects are recognized though, but idea of creating and reinforcing dependency remains central[19].

Both Marxism and Dependencia arguments are explicitly political, and in the debate on political economy they were quickly opposed from the other end of the spectrum. The attempts of the proponents of the above reviewed schools to create a universal theory counted historical facts – failure of the soviet industrialization, poor economic conditions prevailing in the Latin America on one hand, and South Korea and Taiwan, developed under political protectorate, on the other. Generally, by the end of the 80s' emergence of the Asian newly industrialized nations as well as changing international political and economic conditions announced the victory of free-market capitalism over socialism, albeit not without few exceptions.

However, in spite of the fact that dependency analysis seems to have lost its power in the view of the global economic forces, dependency theory's focus on international pressures provides valuable insights, which are also reflected in non-neoclassical framework. Thus, for example, dependentists argue that benefits of FDI are distributed between the multinational and the host unfairly or unequally, i.e. the price the country pays for what it gets is too high, i.e. the company draws off the profits that could have been reinvested and used to finance internal development. Another line of arguments is that multinational corporations distort local economy by squeezing out local entrepreneurs, by using capital-intensive technologies thus contributing to the higher level of unemployment, by aggravating distribution of income, and by changing culture of the host country imposing alien consumer tastes and preferences. Another preposition is that foreign investors undermine political processes by structuring host authorities, home governments and international systems to respond to their multinational needs[20].

Western-type theories of the market economy, as well as the strategies developed on their basis interpret the role of private investments quite differently. The basic presumption of neo-classicists is that market economy, trade and all private investment have positive effects on development, expressed in the raised income and social welfare in the host country, unless optimum conditions are distorted by protectionism, monopolies and externalities. FDI is viewed as additional investments, and if there is unemployment and shortage of capital, which is typical for developing countries, FDI leads to increase in employment, output, income, technology and thus, ultimately, to economic growth of the host country. In addition, through increased level of export and

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19 Gordon, W. Institutionalism and Dependency. *Journal of Economic Issues*. 1982, 216(2): 569-546; Kebschull, D.

20 Moran, T. H. Multinational Corporations and Dependency: a Dialogue for Dependentistas and Non-Dependentistas. *International Organization*. 1978, 32(1): 79–100.

substitution of import these investments act as an agent for filling the foreign exchange gap, which affects the balance of payments positively. Such unconditional statements are supported by various designs of investment multiplier and accelerator for simple growth models of the Harrod-Domar type and their refined versions of Kurihara, Solow and others. Investment in these models is presented as crucial strategic variable, which plays an important role in the development strategies for the Third World, for instance, in the Big Push model, in Hirschmann's unbalanced growth proposition and Rostow's take-off concepts[21].

Neoclassical assumptions of the increased global welfare through certain efficiency do have a ground, as profits are maximized through shifting resources from low return to high return areas and buying the inputs where prices are low. However, it should be considered that MNEs emerge and operate because of market imperfections as discussed earlier, which limits the explanatory value and validity of neoclassical assumptions. Conventional wisdom of FDI role in increasing welfare is opposed by assumptions of welfare losses from inward FDI since under direct product market competition MNEs capture market shares from the indigenous firms, thus reducing their profits. This adverse effect on welfare is not compensated by the profits of MNEs, which are often repatriated[22]

The extreme approaches under the pure market economics disregard such issues as whether foreign enterprises supplement domestic investments or displace them. Employment- and wages- related distortions are not addressed as well. It is believed that such distortions, if they exist, are outbalanced by the well-functioning market mechanisms. This assumption is criticized by the economists who believe that improved resource allocation has to be judged against the increases in market imperfections.

In the range from liberal to radical approaches, less ideologically shaped researchers analysing causes and consequences of FDI seem to hold a more realistic position on the issue. The effects of FDI on the host country can be classified into economic (macro and micro), political, and social ones. Macroeconomic effects may include implications for such economic variables as output and balance of payment. Microeconomic effects pertain to structural changes in economic and industrial organization, e.g. creation of more competitive environment, or, conversely, worsening of monopolistic and/or oligopolistic elements. Political effects may include issues of national sovereignty and security. Social effects can relate to creation of foreign elite as well as cultural changes in customs and tastes. The main concern of the current article is the economic effects of FDI in the host country. These are FDI effects on capital provision, output, employment, training, technology, market structure, productivity, trade flows, and sustainable economic development, which will be discussed in turn in the current section. The discussion centres on the role of FDI in developing countries and countries in transition aiming to show that along with numerous benefits, FDI has it costs, and the effects of FDI in the non-advanced economies are not favourable in all cases all the time.

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21 Kebschull, D.

22 Leahy, D.; Montagna, C. Unionization and Foreign Direct Investment: Challenging Conventional Wisdom? *Economic Journal*. 2000, 110 (462): C80-C92.

4. Interrelation between FDI and Capital Supply

One of the most vivid and important effects of FDI is provision of capital. Here is the two-gap model, an extension of the Harrod-Domar growth model, which is frequently used for analysis of the benefits of foreign transfers, including FDI. The model centres around two economic problems constraining the economic growth in developing countries and transitional economies. The first constraint is the shortage of domestic savings to finance investment needed to attain a certain target growth rate of output; the second is shortage of foreign exchange, the difference between imports and exports to finance imports, again 'needed' to attain the same target growth rate[23].

With reference to the model, it is assumed that FDI flattens out these gaps. First, it is argued that through increase in export and decrease in imports, which positively affects the balance of payments, FDI fill the foreign exchange gap of the host country. Second, it is argued that FDI increases inflow of financial resources available for investment. The main reason for this assumption is that MNCs and TNCs (expanding primarily though FDI) have higher investment potential and easier access to financial markets compared to local firms. In particular, Alfaro, Chanda, Kalemhi-Ozcan and Sayek[24] argue that in order to take advantage of the new knowledge domestic firms need to alter everyday activities and, more generally, reorganize their structure, buy new machines, and hire new managers and skilled labour. Although some local firms might be able to finance new requirements with internal financing, the greater the technological knowledge gap between their current practices and new technologies, the greater the need for external finance, the access of which is in many cases restricted for the local entrepreneurs.

The role of FDI in the context of development of domestic financial markets is examined by Razin, Sadka and Yuen[25]. According to the researchers, FDI can play a double role in case of the weak domestic credit market, i.e. when domestic savings cannot be channelled efficiently into domestic investment. First, FDI may mobilize domestic saving, which through revived domestic market is channelled to domestic investments (not without welfare losses though), and supply foreign saving on top of the domestic. Second, traditional gains are obtained through trade. However, in case of the well-developed domestic credit market, when domestic savings can be channelled into domestic investment in the absence of an equity market, the first role does not generate any gains, and gains from trade are considerably decreased. Thus, FDI effects on welfare can well be negative.

In the discussion of the role of FDI in capital formation a critical issue is complementarities with regard to domestic investment. On one hand, an inflow of FDI may

23 Michalopoulos, C. Production and Substitution in Two-Gap Models. *Journal of Developmental Studies*. 1975, 11(4): 343–356.

24 Alfaro, L.; Chanda, A.; Kalemhi-Ozcan, S.; Sayek, S. FDI and Economic Growth: the Role of Local Financial Markets. *Journal of International Economics*. 2004, 64(1): 89–112.

25 Razin, A.; Sadka, E.; Yuen, C.-W. An Information-Based Model Of Foreign Direct Investment: The Gains From Trade Revisited. *International Tax and Public Finance* [interactive]. 1999, 6(4): 579–596 [accessed 2008-12-01]. <http://www.nber.org/papers/w6884>.

encourage domestic investment through complementarities between foreign and domestic firms in their business strategy, firm resource, production, and so forth. For example, if foreign investors use joint ventures as the mode of entry into the host country market, their investment will typically encourage local firms to match inward FDI. In cases where foreign affiliates use local suppliers and/or distributors, the inflow of FDI can also create new business opportunities for indigenous investors, and thus "pull in" domestic investment through backward and forward linkages. TNCs can compete in a foreign market because they possess decisive advantages over local firms in the form of intangible assets such as technological and organizational capabilities. Thus, the entry of TNCs may suppress domestic entrepreneurship, and "crowd out" domestic investment. The majority of empirical studies tend to suggest that the inflow of FDI exerts a positive effect on the domestic capital formation in the host country[26].

Being a predominant form of capital flows to emerging economies, FDI has its advantages and disadvantages in comparison to other sources of foreign finance. FDI represents itself a more stable source of finance and a more long-term commitment compared to other financial flows. In addition, FDI is easier to service than commercial loans, since profits tend to be linked to the performance of the host economy. However, some economists, as for instance, Lall and Streeten[27] hesitate about FDI superior ability to provide capital. They believe FDI is very expensive source of foreign finance. They point out that capital contributed by MNCs may represent value-relevant capitalized intangible assets, such as patents, brand name, goodwill or copyrights. In this respect FDI flows are very expensive and inferior to other sources of finance.

5. FDI Effect on Output Growth

FDI effect on output and growth in the host country seems to be one of the most complex and important. For the effect of output to materialize, it is necessary to increase capital stock of the host country as a result of investment or, in case of take-over, a more efficient utilization of existing resources. This effect is more important for developing countries, where inward investment is deemed to be the means of boosting economy. Theories of economic growth and development mainly refer to the increase of per capita income, which is influenced by such factors as capital build-up, human capital, rate of the growth of population, level of technological advancement, discovery or more efficient use of natural resources, etc. Since FDI is a significant factor for capital accumulation, it should also be deemed to play an important role in increasing output and growth and promoting economic development.

The idea of an effect of FDI on economic growth was picked up early in the literature. In the early neoclassical growth models FDI was considered simply as a second ca-

26 Xu, G.; Wang, R. The Effect of Foreign Direct Investment on Domestic Capital Formation, Trade, and Economic Growth in a Transition Economy: Evidence from China. *Global Economy Journal*. 2007, 7(2): 1–21.

27 Moosa, I. A. *Foreign Direct Investment: Theory, Evidence and Practice.* Palgrave, 2002.

pital input factor in production. Using the standard neoclassical growth model[28] Brems argued that FDI simply adds to the accumulation of physical capital and hence to economic growth. However, there was one important drawback of this approach. Generally, capital accumulation in the neoclassical growth model had only transitory effects on per capita growth. Permanent positive per capita growth rates could only be achieved by exogenous, unexplained technological progress. Thus, in the Brems's model the effects of FDI on per capita growth were also only transitory and not permanent.

However, empirical evidence in the 1980s showed that some economies were able to maintain high growth rates continuously, contradicting the neoclassical perception, which was generally not possible to explain by exogenous economic growth model. Economic growth theory was therefore revised, resulting in emergence of new growth theories and endogenous growth models towards the end of the 1980s[29]. Romer[30] was the first to reveal the decreasing-returns problems of the neoclassical growth model by modelling increasing returns through knowledge spillover. He managed to model positive long-run per capita growth rates via technology diffusion. This idea was then transferred to economic growth models of FDI. Romer[31] emphasised the existence of important "idea gaps" between developed and developing economies. He argued that FDI is an important instrument for the transfer of this knowledge from the developed to the less developed countries by delivering spillover to the entire economy. A widely recognised model of the spillover effects of FDI is the one developed by Borensztein, De Gregorio and Lee[32].

The role of FDI as an efficient device for importing modern technology and as a catalyst fostering economic growth via increased output can be traced at both micro and macro levels[33] – at the micro level the performance of company and on macro level the composition of the output and, consequently, the growth of the host country economy. If the host country maintains full employment, and the efficiency of domestic utilization of resources is equal to the one associated with FDI, the impact of FDI on output will be zero. If FDI employs resources that would otherwise remain uninvolved the output resulted from FDI excluding all remittances will be equal to the increase of output of the recipient countries. If the shift from less productive to more efficient sectors of economy occurs due to FDI, then the local output will increase.

28 Brems, H. A Growth Model of International Direct Investment. *American Economic Review*. 1970, 60(3): 320–331.

29 Kottaridi, C. The 'Core-Periphery' Pattern of FDI-led Growth and Production Structure in the EU. *Applied Economics*. 2005, 37(1): 99-113.

30 Romer, P. M. Increasing Returns and Long-Run Growth. *Journal of Political Economy*. 1986, 94(5): 1002–1037.

31 Romer, P. Idea Gaps and Object Gaps in Economic Development. *Journal of Monetary Economics*. 1993, 32(3): 543–573.

32 Borensztein, E.; De Gregorio, J.; Lee, J.-W. How Does Foreign Direct Investment Affect Economic Growth? *Journal of International Economics.* 1998, 45(1):115–135.

33 Choong, C.-K.; Yusop, Z.; Soo, S.-C. Foreign Direct Investment and Economic Growth in Malaysia: the Role of Domestic Financial Sector. *Singapore Economic Review*. 2005, 50(2): 245–268.

Although new growth theorists like to attribute a special growth effect to FDI because of its know-how spillover nature, some economists, such as Lall and Streeten[34], can still reveal adverse effects of FDI on growth. They argue that the profits generated as a result of MNC output and practices are more likely to flow to the home country rather than be re-invested in the host country, which leads to the lower rate of savings. The supporters of this view also state that MNCs can undermine local economic control and act not necessarily in the interests of the host country. It is also argued that MNCs can create less competitive market structure.

Effects of FDI on economic growth and development are thoroughly examined in empirical literature. The results of numerous studies are heterogeneous. While some empirical findings prove very strong positive link between FDI and growth, certain studies do not determine significant correlations.

Balasubramanyam, Salisu and Sapsford[35] analysed the role of FDI in promoting economic growth. The authors concluded that the effects depend on the size of the domestic market and the competitive climate in relation to the local producers.

Using the model of endogenous growth Borensztein[36] tested 69 developing countries from 1970 to 1989. The results of the study suggest the following conclusions: first, FDI being an important vehicle of transfer of advanced technology from the industrial countries (or knowledge societies) to the developing ones is more likely to contribute to the growth of the host country compared to the domestic investments.

A number of studies by Durham[37] analyse the link between FDI and the economic growth emphasizing the role of financial infrastructure and institutional variables in macroeconomic performance (cross-country analyses of 18 OECD and 62 non-OECD countries performed during the period from 1979 through 1998. Durham concluded that the higher degree of financial and institutional absorptive capacity the higher effectiveness of the effect of FDI on economic growth.

Durham studies were supplemented by the empirical study of Vu Le and Suruga[38]. Using the sample of 105 countries, both developed and developing, the scientists examined interrelation of the FDI, public expenditure and economic growth as for the period 1970 – 2001. The authors argue that FDI along with public capital and private investment forward economic growth.

34 Moosa, I. A.

35 Balasubramanyam, V. N.; Salisu, M.; Sapsford, D. Foreign Direct Investment as an Engine of Growth. *Journal of International Trade & Economic Development*. 1999, 8(1): 27-40.

36 Borensztein, E.; De Gregorio, J.; Lee, J.-W. How Does Foreign Direct Investment Affect Economic Growth? *Journal of International Economics.* 1998, 45(1):115–135.

37 Durham, B. J. Absorptive Capacity and the Effects of Foreign Direct Investment and Equity Foreign Portfolio Investment on Economic Growth: the Role of Domestic Financial Sector. *European Economic Review*. 2004, 48(2): 285-307; Durham, B.J. Economic Growth and Institutions: Some Sensitivity Analyses, 1961-2000. *International Organizations*. 2004, 58(3): 485-529.

38 Vu Le, M.; Suruga, T. Foreign Direct Investment, Public Expenditure and Economic Growth: the Empirical Evidence for the Period 1970-2001. *Applied Economics Letters*. 2005, 12(1): 45-49.

Several studies on Asian economic development reveal positive effects of FDI on economic growth. For instance, Fan and Dickie[39] examining contribution of FDI component of foreign capital to growth and stability in the ASEAN-5 economies found that FDI accounted for 4 to over 20 percent of GDP growth in the ASEAN-5 during the period from 1987 to 1997. Moreover, FDI inflows were found to be a stabilizing factor during the Asian financial crisis. Zhang[40], however, warns that the extent to which FDI is growth-enhancing depends on country-specific characteristics.

In addition to cross-country studies, numerous single-country analyses of the effects of FDI on growth have been conducted. For example, Choong, Yusop and Soo[41] investigated relationship between FDI and economic growth in Malaysia. Authors underlined that transferring and absorption of managerial skills and technological innovation associated with FDI largely depend on the status and capacities for expansion of the financial sector of the recipient country.

Examining the relationship between FDI and economic growth in Lithuania during 2000-2006 Tvaronaviciene and Grybaite[42] found a strong positive relationship between FDI stock and GDP growth. Further, expanding the opinion of some authors that the inflows of FDI into different economic sectors exert different effects on economic growth due to e.g. the difference in technology absorption by different sectors, the authors estimated the impact of FDI on different economic activities in Lithuania, applying correlation analysis. As a result, positive, negative, significant and insignificant correlation coefficients were determined both in "attractive" and "unattractive" economic activities from the FDI point. The authors concluded that FDI impacts majority of economic activities, however, the extent of that impact differs. Third, more "attractive" economic activities with higher FDI intensity display higher concentration, which can result in crowding out of local companies from FDI intensive economical activities in Lithuania.

In general, consistent with the majority of empirical studies, host countries enjoy the positive externalities of FDI. Some studies emphasize the importance of certain macro and micro economic variables involved in the above-mentioned analyses, which appear to be essential for the increase of output and economic growth. Very few studies argue adverse effects of FDI, namely crowding out of domestic savings and possibility for enclave economies.

Technology transfer results in upgrading of human capital, which, as argued, contributes to the national competitiveness[43]. Transfer and diffusion of technology is therefore the predominant issue when discussing the role of FDI in promoting economic growth,

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39 Fan, X.; Dickie, P. M. The Contribution of Foreign Direct Investment to Growth and Stability. *ASEAN Economic Bulletin*. 2000, 17(3): 312–324.

40 Zhang, K. H. Does Foreign Direct Investment Promote Economic Growth? Evidence from East Asia and Latin America. *Contemporary Economic Policy*. 2001, 19(2): 175–185.

41 Choong, C.-K.; Yusop, Z.; Soo, S.-C.

42 Tvaronavičienė, M.; Grybaitė, V. Impact of FDI on Lithuanian Economy: Insights into Development of Main Economic Activities. *Journal of Business Economics & Management*. 2007, 8(4): 285–298.

43 Gugler, P.; Brunner, S. FDI Effects on National Competitiveness: A Cluster Approach. *International Advances in Economic Research*. 2007, 13(3): 268–284.

accumulating capital as well as restructuring social and organizational networks and production systems. Knowledge through MNCs can leak to its subsidiaries in the host country, creating effect of spillover, which, according to Blomstrom and Kokko[44], is one of the major reasons the host country governments try to attract FDI inflows.

The impact of FDI, however, depends on the type of activity undertaken and the absorptive capacity of the host state. On the contrary, the study of Walkenhorst[45] concludes that FDI brings not only much needed capital to the Central Europe, but also managerial and technological skills that are similarly in short supply.

6. FDI and Market Structure

FDI directly affects market structure in the host country. In the context of market structure FDI can improve the competitive forces or, on the contrary, worsen the situation by creating oligopolistic or even monopolistic forces.

In the absence of local monopolistic/oligopolistic powers, there is a danger of foreign companies obstructing the development of indigenous firms and dominating the local market due to the size, scale of activities and parent company back-up.

The preceding discussion prompted OECD to issue some relevant guidelines for MNCs aiming to encourage behaviour boosting the competition, e.g. to refrain from entering into or carrying out anti-competitive agreements such as price fixing or collusive tenders. to conduct all of their activities in a manner consistent with all applicable competition laws, and to cooperate with the competition authorities[46].

Although FDI can be an important source of productivity growth, especially in developing countries, some authors argue that productivity is not necessarily applicable to FDI, but affected by other factors, e.g. degree of utilization of the company resources, quality of the existing personnel, industrial development, and degree of governmental or other restrictions.

Numerous analyses on productivity and FDI in both developing and developed economies exist. The evidence on higher productivity for foreign-owned plants is ample. Bonelli[47] finds that FDI contributed to the increased productivity and competitiveness in Brazil. The study carried out by Okamoto and Sjoholm[48] reveals positive effects of FDI on manufacturing productivity growth in Indonesia. The authors conclude that the foreign share of total factor productivity growth is larger than the foreign output share,

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44 Blomstrom, M.; Kokko, A. Multinational Corporations and Spillovers. *Journal of Economic Surveys*. 1998, 12(3): 247–277.

45 Walkenhorst, P. Foreign Direct Investment, Technological Spillovers and the Agricultural Transition in Central Europe. *Post-Communist Economies*. 2000, 12(1): 61–75.

46 *The OECD Guidelines for Multinational Enterprises: Review 2000* [interactive]. OECD, 2000 [accessed 2008-12-01]. <http://www.olis.oecd.org/olis/2000doc.nsf/LinkTo/NT00002916/$FILE/00082259.pdf>.

47 Bonelli, R. A Note on Foreign Direct Investment and Industrial Competitiveness in Brazil. *Oxford Development Studies*. 1999, 27(3): 305–328.

48 Okamoto, Y.; Sjoholm, F. FDI and the Dynamics of Productivity in Indonesian Manufacturing. *Journal of Development Studies*. 2005, 41(1): 160-182.

but the foreign share of labour productivity growth is relatively low. Labour productivity in manufacturing foreign affiliates is discussed in the mentioned paper of Hunya and Geishecker[49]. Based on the sample of seven countries the authors observed that on average labour productivity was higher in foreign subsidiaries compared to domestic firms during the period from 1996 to 2001. (See Table 1). Vahter[50] in his analysis based on the panel data from Slovenia and Estonia concludes that foreign owned firms have on average higher labour productivity levels than domestic enterprises in both countries. When firms are classified by their export orientation, for Estonia the export orientated FDI show lower labour productivity compared to Slovenia, where productivity is significantly higher. This difference in findings also proves different competitive advantages of these two countries – Slovenia's advantage is higher value added and skilled labour and higher productivity related sectors, while Estonia attracts FDI more due to lower costs compared to investors' home countries.

Table 1. Labour productivity gap between foreign investment enterprises and domestic enterprises in manufacturing, 1996–2001

	1996		*1998*		*2001*
Estonia	1.58		1.36		1.19
Czech R.	1.73		1.65		1.56
Hungary	1.70		1.56		1.60
Poland	1.45		1.54		1.58
Slovakia	1.66		1.96		1.63
Slovenia	1.94		1.86		1.66
Romania	N/A		1.77		1.57

Source: Vienna Institute for International Economics (Hunya and Geishecker, 2005)

Pocatello and Rabbiosi[51] investigated the impact of inward FDI occurring through acquisition upon the local target company's labour productivity in the medium term after the acquisition. Using the data on foreign acquisitions of Italian firms in manufacturing industry during the period 1994-1997, the researchers proved that inward FDI occurring through acquisition does improve the target company's labour productivity in the medium term after the acquisition.

Nunnenkamp[52] expresses critical views on FDI promoting welfare and economic prosperity. Based on the statistical data provided by the World Bank (Figure 1), the

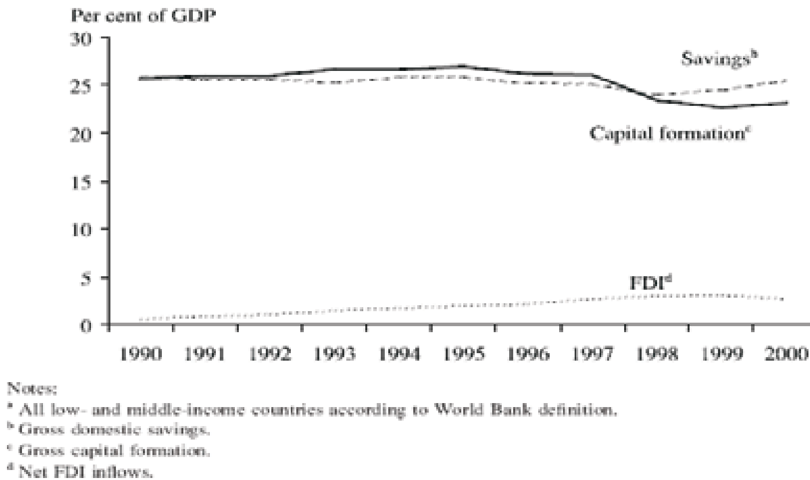
49 Hunya, G.; Geishecker, I. Employment Effects of Foreign Direct Investment in Central and Eastern Europe. *WIIW Research Reports* [interactive]. 2005, No. 321. [accessed 2008-12-01]. <http://wiiw66.wsr.ac.at/pdf/RR321>.

50 Vahter, P. The Effect of Foreign Direct Investment on Labour Productivity: Evidence from Estonia and Slovenia. *University of Tartu – Faculty of Economics and Business Administration working paper series*. 2004, 32: 3–4.

51 Poscatello, L.; Rabbiosi, L. The Impact Of Inward FDI On Local Companies' Labour Productivity: Evidence From The Italian Case. *International Journal of the Economics of Business*. 2005, 12 (1): 35–51.

52 Nunnenkamp, P. To What Extent Can Foreign Direct Investment Help Achieve International Development

author concludes that the role of FDI in formatting capital stocks is overestimated. He also blames the policymakers who provide tax incentives to foreign investors, thus discriminating the local investors and undermining the development of domestic entrepreneurship.



So*urce: World Bank, 2002 (Nunnenkamp , 2004)*

Figure 1. Contribution of FDI and Domestic Savings to Capital Formation in Developing Countries (a), 1990–2000

Nunnenkamp[53] emphasizes that the benefits of FDI are strongly concentrated and unevenly distributed. FDI targets limited number of developing countries. Predominantly, these countries are either very large economies, such as China, Brazil, Indonesia, or fairly advanced economies as Hong Kong, Singapore, Korea, and Czech Republic.

Final Remark

The effects of FDI is a highly controversial and contentious issue. In theory, the effects of FDI on the host country's economy can be highly positive, but the benefits are not realized automatically. There are certain conditions to be satisfied for the effects to materialize. The empirical evidence is ambivalent – while FDI effects in many cases are positive, certain negative aspects can be observed, especially in the context of developing counties and transition economies.

Goals? *World Economy.* 2004, 27(5): 657–677.

53 *Ibid*., p. 657–677.

Conclusions

On the basis of scientific literature, FDI theories were compared and analysed as well as the effects of FDI on economic growth and development were thoroughly examined in the empirical literature. The results of research lead to the following conclusions:

1. Although FDI is frequently examined across different disciplines such as international economics, economic geography, international business and management, none of the theories can fully explain phenomena of FDI. Therefore, comprehensive analysis of FDI from theoretical and empirical perspectives is indispensable.

2. Different perspectives imply emphasizing different aspects of FDI. From the perspective of the investing country, FDI can be classified into a horizontal FDI, a vertical FDI and a conglomerate FDI.

3. The main theories are neoclassical one, the industrial organization theory, the new trade theory and the Kojima hypothesis.

   a. The neoclassical financial theory of portfolio is based on different interest rates. It states that capital moves from countries where interest rates are low to those where interest rates are high; it also assumes that the rate of risk is low and there are no barriers to the movement of investment, and transactions costs are not taken into account.
   b. According to the industrial organization theory, multinational enterprises and FDI focus on the strategic behaviour of firms and the structure of markets.
   c. The new trade theory tackles the effects of market imperfections of trade patterns and provides explanations for international trade driving forces (in cases when the similar goods and services are both imported and exported), and for emergence of MNEs and FDI. According to this theory, firms benefit from the scale economy and proprietary technology by seeking to sell their products on global markets. Firms, which operate in one country, may be able to dominate niches for their products, while firms in other countries will have advantages in other market niches.
   d. The Kojima's hypothesis is rather ambivalent as it classifies into FDI to trade-oriented and anti-trade-oriented ones. The trade-oriented FDI generates an excess demand for imports and an excess supply of exports. Moreover, this type of FDI promotes trade as well as a beneficial industrial restructuring and it leads to welfare improvement in both countries. The anti- trade-oriented FDI, on the other hand, has adverse effects on trade and it promotes unfavourable restructuring in both countries.

4. As theoretical analysis showed, the effects of FDI are highly positive, but the benefits are not realized automatically. The results of numerous empirical studies are heterogeneous. In contrast to theoretical analysis, the results of empirical studies proved certain negative aspects of the effects of FDI. For example, the effects of FDI on economic growth per capita were also only transitory and not permanent. The effects of FDI on the host country can be classified into economic (macro and micro), the political, and the social ones. The main economic effects of FDI in the host country are capital provision, output, labour productivity, the increase of employment and training, innovation and technology, market structure, trade flows, and sustainable economic development.

a. Technology impact of FDI, however, depends on the type of activity undertaken and the absorptive capacity of the host state.
b. FDI directly influences market structure in the host country.
c. FDI can be an important source for a growth in labour productivity. It might be especially true in developing countries. However, some authors argue that productivity is not necessarily applicable to FDI, but is affected by other factors as well.
d. The effect of FDI on sustainable development is doubtful as the benefits of FDI are strongly concentrated and unevenly distributed.

To generalize, the effects related to FDI depend on specific characteristics of a country such as size of the domestic market and the competitive climate in relation to the local producers.

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POŽIŪRIŲ Į TIESIOGINIŲ UŽSIENIO INVESTICIJŲ VAROMĄSIAS JĖGAS BEI TIKĖTINAS IŠDAVAS KRITINĖ APŽVALGA

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Santrauka. *Daugelyje pereinamosios ekonomikos šalių tiesioginės užsienio investicijos, vertinamos kaip vienas iš ūkio plėtros veiksnių, buvo ir yra laikomos svarbia produktyvumą, ir ekonominį augimą skatinančia sąlyga. Toks palankus požiūris į tiesiogines užsienio investicijas (toliau – TUI) lėmė daugelio valstybių ekonominę užsienio kapitalo politiką: besivystančios šalys visokeriopai skatina tarptautinio kapitalo srautus, suteikdamos tiek mokestines lengvatas, tiek išskirtines strateginio investuotojo teises privatizuojant svarbius valstybės objektus. Tačiau tam tikri atvejai verčia abejoti, ar TUI visada užtikrina produktyvumo augimą, parduodamų prekių ir suteikiamų paslaugų kokybės bei kiekio didėjimą. Nepaisydami dominuojančio pozityvaus požiūrio kai kurie mokslininkai įrodinėja, jog užsienio kapitalo poveikis šį kapitalą įsileidžiančiai šaliai tam tikrais atvejais gali ne tik neduoti laukiamo efekto, bet, priešingai, stabdyti vietinio ūkio ekonominę plėtrą.*

Šiame straipsnyje kaip tik nagrinėjama, kokios varomosios jėgos lemia užsienio kapitalo srautų dydį ir kryptis bei kokios pasekmės yra tikėtinos užsienio kapitalui įsiliejus į konkurencinę, monopolinę arba oligopolinę ūkio šaką. Autorės kritiškai analizuoja pagrindines TUI judėjimo teorijas. Straipsnyje keliami vietinių bei užsienio investicijų suderinamumo klausimai, gvildenama finansinio sektoriaus išsivystymo lygio bei TUI poveikio ekonominiam augimui ryšio problemos. Pabrėžiama, jog atskirų užsienio kapitalo srautų poveikis kai kurioms šalies recipientės ūkio šakoms gali būti ne tik priešingas, bet ir laikui bėgant keisti savo kryptį arba poveikio stiprumą, t. y. kai kuriais atvejais TUI teigiamai veikia kapitalą priimančią šaką, o kai kuriais – neigiamai; laikui bėgant bei vykstant ūkio transformacijoms teigiamą TUI poveikį gali pakeisti neigiamas.

Apibendrinant galima pasakyti, kad užsienio kapitalo atėjimas į besivystančią šalį neturėtų būti besąlygiškai skatinamas, kadangi tam tikrais atvejais vietinės šalies ekonomikos augimas gali būti stabdomas. Konkurencinių, technologinių bei kitų sąlygų, kuriomis užsienio kapitalas veikia rinkoje, specifika turi didelės įtakos bendram atskirų TUI srautų poveikiui vietinės ekonomikos plėtrai.

***Reikšminiai žodžiai**: socialiniai mokslai (vadyba ir administravimas), tiesioginės užsienio investicijos, tiesioginių užsienio inesticijų veiksniai, tiesioginių užsienio inesticijų išdavos, besivystančios šalys.*

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