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BOOK REVIEW ESSAY

How to Improve the Developmental Impact of Foreign Direct Investment: A Review

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Most economists would probably agree that it is not sufficient for developing countries to attract more foreign direct investment (FDI). Even for host countries with high attractiveness to FDI, the challenge remains to ensure that FDI fosters economic development, e.g., by inducing technological and managerial spillovers, generating additional employment and income opportunities, and alleviating world-market integration. However, the consensus hardly goes further than this. It continues to be highly controversial what, if anything, host-country governments can and should do to improve the developmental impact of FDI in Third World economies.

Two recent UNCTAD publications on the theme "FDI policies for development" do not provide ready-made solutions for policymakers in developing countries. Nevertheless, the detailed assessment of contentious FDI policies offers valuable insights. This refers especially to the *World Investment Report 2003* which, in addition to the regular part on recent FDI trends, focuses on the developmental dimension of bi-, pluri-, and multilateral investment agreements (UNCTAD 2003a: Part 2). The report discusses eight key issues: the definition of investment, national treatment of foreign investors, nationalization and expropriation, dispute settlement mechanisms, performance requirements, FDI incentives, technology transfers, and competition policy. As concerns performance requirements, UNCTAD (2003a) draws on a concurrent publication offering detailed evidence from selected host countries (UNCTAD 2003b). Country studies on the incidence

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Remark: This is primarily a review of: UNCTAD, *World Investment Report 2003. FDI Policies for Development: National and International Perspectives.* New York 2003. United Nations. XIX, 303 pp. and UNCTAD, *Foreign Direct Investment and Performance Requirements: New Evidence from Selected Countries.* New York 2003. United Nations. XII, 306 pp. – Please address correspondence to Peter Nunnenkamp, Kiel Institute for World Economics, Duesternbrooker Weg 120, 24100 Kiel; e-mail: nunnenkamp@ifw.uni-kiel.de

and impact of performance requirements relate to Chile, India, Malaysia, and the Republic of South Africa. In addition, the volume summarizes the experience of developed countries and provides an overall assessment.

The special attention given to performance requirements may surprise many readers. Why so much ado even though the incidence of performance requirements has declined sharply? The TRIMs (Trade-Related Investment Measures) Agreement under the WTO umbrella prohibits local content obligations, export restrictions as well as trade-balancing requirements. Various developing countries have tied their hands further by giving up performance requirements related to local equity participation, employment, exports, and technology transfers in the context of bilateral investment treaties (BITs) and free trade agreements (UNCTAD 2003b: 3; see also the informative overview table in UNCTAD 2003a: 122). Even a country such as India, which imposed performance requirements on one in three FDI projects in the early 1990s, has relaxed most performance requirements other than the 100 percent export obligation for firms operating in export processing zones (UNCTAD 2003b: 110). According to survey results presented by the European Round Table of Industrialists (2000), performance requirements have become less restrictive since the early 1990s in almost all developing countries under consideration.

Yet, the focus on performance requirements is appropriate, if only to unmask the one-sidedness and hypocrisy of many opponents and proponents. Unwarranted generalizations are common on both sides of the debate. Strict opponents of performance requirements, including business representatives and trade negotiators in developed countries, pretend that it would be in the developing countries' own interest if they agreed to tighter discipline with respect to performance requirements. However, there is little, if any, empirical evidence supporting the argument that developing countries could attract more FDI in this way. The results of several studies on the effects of BITs on FDI in signatory countries can be summarized as follows: "Policymakers are well advised not to put their faith in BITs as a major stimulus to higher FDI inflows" (Nunnenkamp and Pant 2003: 12). Correlation analyses of these authors do not support the proposition that performance requirements discouraged FDI in a sample of 28 developing countries. Moreover, as noted above, developing countries would not necessarily benefit from FDI even if less performance requirements were to result in more FDI.

On the other hand, many proponents of performance requirements tend to take it for granted that the "quality" of FDI, i.e., its developmental impact, can be enhanced by applying them. For instance, Kumar (2001:

3152) blames the TRIMs Agreement for curtailing "the ability of the host governments to improve the quality of FDI in tune with their development objectives" (see also Singh 2001). Such statements ignore that the effectiveness of performance requirements is highly ambiguous. Note that Kumar (2001) draws on the well-known study of Moran (1998) to support his own argument that export performance requirements proved useful in encouraging export-oriented manufacturing in Latin American and Asian countries. By contrast, the finding of Moran (1998) that local content requirements were counterproductive, due to the implicit protection of inefficient local suppliers, is suppressed as it conflicts with Kumar's positive assessment.

UNCTAD (2003b) concentrates on performance requirements that are not prohibited by the TRIMs Agreement. The review of the experiences of developing countries reveals a multifaceted picture and defies easy generalizations of the sort just mentioned. Certain types of performance requirements are found more useful (or less costly) than others. For example, the experience with export requirements and local training requirements appears to be better than that with local ownership requirements and technology transfer requirements. But even for particular performance requirements, the effectiveness is shown to be context-specific. For example, the cost-benefit calculus is likely to yield different results in a country such as India, characterized by huge local markets and considerable bargaining power vis-à-vis foreign investors, and in smaller developing countries.

In any case, it is extremely difficult to assess whether performance requirements were instrumental in meeting their stipulated objectives. This is for several reasons. Trade-offs may prevent definite judgments. Local ownership requirements can enhance the diffusion of technology transfers and the chances for local learning, but they are highly likely to come at the cost of less transfers of state-of-the-art technologies (see also Moran 2003). Moreover, most performance requirements that are still in use tend to be "voluntary", rather than mandatory, in the sense that they represent a condition for the receipt of FDI incentives such as tax concessions. Some requirements are intended to correct for undesirable side effects of other government interventions. All this renders it impossible to isolate the impact of performance requirements on the quantity and quality of FDI.

The evidence on export requirements presented in UNCTAD (2003b) clearly exemplifies this problem. How to interpret the finding that multinational enterprises (MNEs) contributed overproportionately to a country's export earnings if, as was frequently the case, import substitution policies resulted in an anti-export bias which the government attempted to offset by

offering export incentives such as tariff cuts or drawback schemes in combination with the commitment of MNEs to meet specified export targets? The verdict depends on the counterfactual considered. Attributing the higher export propensity of MNEs to the link between export requirements and FDI incentives ignores that the first-best solution would have been to tackle the roots of the anti-export bias and, thereby, improve the international competitiveness of local and foreign enterprises. But even under conditions of second best, the effectiveness of export requirements is open to question as unconditional export incentives might have induced more FDI and higher exports of MNEs. Moreover, export requirements applied by a large country as a condition for local market access may divert export-oriented FDI away from smaller host countries which are more competitive in world markets but have less bargaining power.

None of these arguments goes unreported in the summary assessment in UNCTAD (2003b). In the country studies, however, the complexities are often thrown overboard and replaced by simplistic or even inconsistent statements. The study on Chile concludes that "export performance requirements have played an important role in encouraging a greater number of firms to export" (ibid.: 67), even though the previous impact assessment is exclusively about export promotion through subsidies and import facilitation. Likewise, it is misleading to consider the Motor Industry Development Programme of the Republic of South Africa to be a successful example of export requirements only because "some incentive schemes have export-related criteria attached to them" (ibid.: 188) and "the motor vehicle and automotive components sectors appear to be growing in accordance with the objectives of the Programme" (ibid.: 190). In the study on India, contradictory arguments are made to "prove" the case for export requirements. The relaxation of export requirements in the 1990s is held responsible for the declining share of MNEs in India's total exports. Shortly afterwards, a "constantly growing" export activity of some MNEs is perceived to show the positive role of earlier export requirements, "even though the export obligation period ended" (ibid.: 93).

The finding of the country studies in UNCTAD (2003b) that different FDI policies are typically pursued in combination, implying that their effects can hardly be separated from each other, provides sufficient reason to broaden the perspective when discussing host-country efforts to foster the developmental impact of FDI. Furthermore, performance requirements have become part and parcel of international investment agreements (IIAs) which are negotiated at the bilateral, plurilateral, and multilateral level.

They resemble various other contentious elements of IIAs in an important respect, namely the difficulty to strike a balance between international investment rules, deemed necessary mainly by investors and their home countries, and the insistence of host countries on flexible and selective FDI policies and their right to regulate MNEs.

The major strength of UNCTAD (2003a) is to show that the national policy space may shrink in various dimensions through the conclusion of IIAs:

- Conflicts of interest emerge from the very beginning, i.e., when defining investment. The trend in IIAs has been toward a broad asset-based definition, even though most developing countries prefer a narrower definition in order to be able to restrict capital flows which are considered less beneficial than FDI.
- The principle of national treatment is widely accepted, but it may compromise domestic enterprise development and capacity building if applied even before foreign investors have entered a host country (pre-establishment phase).
- As concerns nationalization and expropriation, so-called regulatory takings are a particularly sensitive issue: As almost all government regulations have an impact on the value of private property, an extensive interpretation of regulatory takings may involve "the risk of 'regulatory chill', with governments unwilling to undertake legitimate regulation for fear of lawsuits from investors" (UNCTAD 2003a: 111).
- The tendency for IIAs to include investor-to-state dispute settlement provisions (in addition to the conventional state-to-state dispute settlement provisions) may further undermine the governments' effective ability to regulate, especially when it comes to conflicts between small developing countries and large and powerful MNEs.
- Foreign investors and their home countries call for stronger protection of intellectual property rights in IIAs, although recent empirical analyses support UNCTAD's view that this would not automatically result in more FDI and higher transfers of technology. Nunnenkamp and Spatz (2004) find that the impact of intellectual property rights protection on the quantity and quality of FDI depends on host-country conditions as well as industry characteristics.

UNCTAD suggests reasonable ways of how to ease some of these conflicts. For instance, IIAs may use a broad definition of investment with regard to the *protection* of investment, while provisions on the *liberaliza-*

tion of investment may be restricted to FDI. In a similar vein, the national treatment principle may be applied only after an investment has been made (post-establishment phase).

Other suggestions are less intuitive or remain rather vague. It is obviously true that a regulatory imbalance exists as IIAs increasingly limit the use of performance requirements, whereas IIAs do not constrain the international competition for FDI by means of fiscal incentives and other subsidies. However, it is hardly convincing to request only developed countries to stop the incentives race to the top. According to Oman (2001: 65), "much of the competition for FDI is effectively among governments in the same geographic region, i.e. among relative neighbours." It follows that preferential treatment of developing countries with regard to FDI incentives would hardly strengthen their bargaining position when MNEs start playing potential host countries off against each other to bid up the value of incentives (Nunnenkamp and Pant 2003). As concerns FDI-related technology transfers, UNCTAD claims that there is a clear case for policy support in the host economy. Yet, it remains unclear how exactly governments can induce MNEs "to transfer the technologies that offer the best potential for local development" (UNCTAD 2003a: 129).

Another imbalance criticized in UNCTAD (2003a: Chapter VI) is that IIAs hardly deal with obligations of the foreign investors, nor with home-country measures to encourage development-friendly FDI flows to host economies. And indeed, the predominance of airy declarations over binding commitments of MNEs and home countries is in striking contrast to increasingly stringent host-country obligations. Considering public concerns about outsourcing to lower-cost locations and adverse labor market implications in developed countries, however, it seems unreasonable to expect home countries to provide financial and fiscal incentives to outward FDI or to effectively strengthen the capacity of developing host countries to absorb technology-intensive FDI (ibid.: 155–6). Likewise, the proposed concept of "good corporate citizenship" rests on dubious assumptions. For instance, whatever rules on transfer pricing may be agreed, the call for MNEs to "pay greater attention to contributing to public revenues" (ibid.: 164) is likely to remain wishful thinking unless the host countries stop subsidizing FDI.

Taken together, the two recent UNCTAD publications invite several conclusions on how (not) to improve the developmental impact of FDI:

- The large number of politically contentious issues and the empirical ambiguity concerning at least some of them (notably performance re-

quirements and intellectual property rights protection) indicate that the case for IIAs is much weaker than one might suspect from the proliferation of such agreements and the increasingly binding character of host-country obligations.

- The proliferation of IIAs appears to be mainly because of the pressure of developed countries for more and stricter investment rules. Developing countries may have become aware only lately of the ensuing erosion of the national policy space. Indications include: the mounting opposition against a multilateral investment agreement, which contributed to the failure of the WTO Ministerial in Cancún in September 2003; the recent request of countries such as Brazil and India to renegotiate the TRIMs Agreement in order to regain policy flexibility; as well as Brazil's resistance against a NAFTA-style Free Trade Agreement of the Americas (FTAA), including comprehensive investment provisions. At the same time, there is no convincing evidence that IIAs would result in a larger quantity and higher quality of FDI flowing to developing countries if only the latter adhered to stricter investment rules. Consequently, it is reasonable to conclude that developing countries "should be free to take the risk of losing the investments from foreign firms for the sake of specific development objectives they wish to promote" (UNCTAD 2003b: 39–40).
- Nevertheless, more policy flexibility at the national level and less binding international investment rules cannot be equated with a better developmental impact of FDI. Especially in UNCTAD (2003a), such a bias is shining through repeatedly. The implicit assumption that governments know best which FDI-related technology transfers are needed most (ibid.: 129) is as questionable as the one that traditional methods to preserve national policy space, ranging from "various kinds of exceptions, reservations, derogations, and waivers to transition arrangements" (ibid.: 149), are necessarily development-friendly. Furthermore, in light of the "disenchanting" (Langhammer 1999: 21) experience with special and differential treatment of developing countries in the area of trade policy, it is far from obvious that the application of the same principle in IIAs would enhance the developmental impact of FDI.
- The limitations of flexible and selective FDI policies are not only because of the costs of government failure. The effectiveness of FDI policies also depends on whether they are part of a broader strategy to improve the developmental impact of FDI. Critical elements include the development of local complementary factors of production (e.g., education and

skills, local suppliers, infrastructure and business services) as well as the promotion of interfirm linkages. While UNCTAD (2003a) provides several hints at the importance of such factors, the publications under review are not meant to elaborate a broad-based strategy. This is done elsewhere, e.g., in UNCTAD (2001) where various policy options are discussed to promote linkages between MNEs and local enterprises. It should be noted that many measures suggested there relate to local capacity building, rather than representing FDI policies in a narrow sense.

In summary, market failure is not a sufficient condition for flexible and selective FDI policies to be effective. Taking into account the practical difficulties to design strategic FDI policies, the best rule of thumb for policymakers may be to refrain from pursuing such policies altogether (Hoekman and Saggi 2000: 636), even though UNCTAD does not reach a similarly strong—but, politically, fairly unattractive—conclusion. In any case, policymakers are well advised to look beyond specific FDI policies and tackle the internal bottlenecks to FDI becoming a stronger stimulus to economic progress in developing countries.

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