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Book Part

How to promote development-friendly FDI : an agenda for policymakers in developing and transition countries

How to Promote Development-friendly FDI:
An Agenda for Policymakers in Developing Countries

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1. Why Attractiveness to FDI Is Not Enough

For FDI to help stimulate economic growth and alleviate poverty in developing countries, two conditions have to be met. The first requirement is to improve developing countries' attractiveness to foreign investors. Second, the host-country environment in which foreign investors operate must be conducive to favorable FDI effects with regard to overall investment, economic spillovers and income growth.

To a certain extent, these two requirements involve similar policy challenges for developing countries. The development of local markets and institutions, an investment-friendly policy and administrative framework, as well as the availability of local complementary factors of production can be considered major driving forces of FDI. Hence, better access to FDI depends on policy actions on all these fronts. At the same time, empirical studies strongly suggest that favorable effects of FDI in the host countries would be more likely if these factors figured high on the policy agenda.

Nevertheless, policymakers should be aware that meeting the first condition, i.e., attracting FDI, is no guarantee for reaping benefits from FDI. For all we can tell, it appears much more difficult to benefit from FDI than to attract FDI.[1] Resource-based countries with low per-capita income frequently exemplify this dilemma. Many of these countries report fairly high FDI inflows, but the enclave character of FDI in commodity-related activities renders it unlikely that FDI contributes significantly to economic growth and poverty alleviation.

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[1] For a detailed discussion, see Nunnenkamp (2004).

2. Limitations of Targeted FDI Policies

Against this backdrop, it has been suggested to policymakers in developing countries, e.g., by ECLAC (2003), to put more emphasis on the quality of inward FDI, rather than its quantity. Accordingly, policymakers should pursue a pro-active and targeted approach of encouraging FDI with the desired developmental impact. For several reasons, however, this is easier said than done.

First of all, policymakers are constrained in pursuing selective FDI policies by various rules and obligations enshrined in BITs, FTAs and multilateral agreements (e.g., TRIMS). In other words, some policy tools are no longer available. Performance requirements provide a case in point. Formerly, many policymakers resorted to local-content requirements as a preferred means to foster linkages between foreign companies and local input suppliers (UNCTAD 2001: 166). Local-content requirements are now banned by the TRIMS agreement. This may not cause any harm to developing countries, considering that local-content requirements and the implicit protection of inefficient local suppliers were often found to be ineffective and, sometimes, even counterproductive (Moran 1998).

However, policymakers in developing countries have also tied their own hands in other respects, notably in BITs and FTAs with the United States, e.g., with regard to export performance requirements, the economic case for which tends to be stronger. Furthermore, while developing countries rejected the demand of industrialized countries to conclude a multilateral investment agreement under the roof of the WTO, for fears that such an agreement might have further eroded their flexibility in pursuing FDI policies, various developing countries did enter into FTAs containing FDI provisions that are more binding than anything that was to be expected from an MAI:

- For instance, the FTA concluded by Chile and the United States in 2002, and regarded by the latter to provide a model of "state of the art" FTAs, defines investment in broad terms and covers all governmental measures, at all levels of government, relating to investment in all sectors, including services. Foreign investors are granted freedom from performance requirements as a condition for the establishment or operation of an investment. The agreement also provides a mechanism for investors to pursue claims against host-country governments (investor-state dispute settlement).

- Recent indications are that developing countries will have to agree to similarly strict obligations when negotiating FTAs and BITs with the EU. Most notably, the EU appears to be following the United States in pressing for pre-establishment rights in favor of European investors.

Pro-active and targeted FDI policies are not only constrained by contractual obligations. At the same time, the effectiveness and efficiency of still existing policy options are sometimes highly questionable. This refers especially to incentives granted to foreign investors whose engagement is deemed by policymakers to have desirable developmental effects. Comprehensive statistics on the use and significance of FDI incentives do not exist. In recent years, however, few countries appear to have competed for FDI without any form of subsidies (UNCTAD 1998: 102–3). It would be good news if the policy of subsidizing FDI were to change, but this is unlikely to happen.

Policymakers may have a point when dismissing the argument of many economists that FDI incentives are ineffective in increasing FDI inflows. Incentives can make a difference when it comes to an investor's final locational choice between short-listed countries with similar economic fundamentals (Oman 2001). FDI incentives may even be economically efficient to the extent that they bridge the possible gap between private returns to FDI and higher social returns (Blomström and Kokko 2003).

Social returns may exceed private returns to FDI if the host country benefits from FDI-induced spillovers, enhancing the productivity of local firms. However, "the elusive nature of spillovers makes it difficult to justify the use of investment incentives on the scale they are being used today" (Hoekman and Saggi 2000: 638). Spillovers cannot be taken for granted, and they are impossible to quantify (which would be required in order to get an idea on the appropriate amount of incentives). Moreover, the available evidence reveals that productivity-enhancing spillovers materialize only if the host country has reached a threshold of sufficient local capabilities to absorb superior technologies and knowledge of foreign investors.

This has obvious policy implications which are disliked, however, by policymakers in many developing countries. First, FDI incentives are no substitute for locational strengths related to economic and institutional fundamentals. Second, "to justify FDI incentives, there is a reason to simultaneously subsidize local firms to strengthen their capacity to absorb foreign technology and skills" (Blomström and Kokko 2003: 19). In this context, it may be noted that the Irish success story in attracting FDI and benefiting from FDI is at least partly because various incentives, including low taxes, were made available to foreign and local investors alike.

Stopping the "race to the top" in granting discretionary FDI incentives should figure high on the policy agenda. However, it is somewhat naive to call for a policy change in this respect. While there is a strong economic case for not taking part in incentives-based competition for FDI, FDI incentives are politically attractive: Host-country governments can point to visible results of their promotional efforts when an FDI project is attracted, whereas the costs of incentives are typically widely spread and hardly visible. The built-in bias towards offering overly generous FDI incentives is clearly reflected in failed attempts at international policy coordination, which seems key to escaping the prisoner's dilemma of host-country authorities when MNEs start playing the authorities off against one another to bid up the value of incentives. Finally, it would help developing countries very little if only industrialized countries were restrained in subsidizing FDI, considering that competition for FDI is mostly among relative neighbors (Oman 2001: 65).

3. Some Do's and Dont's with Regard to FDI Policies

Compared to incentives-based competition for FDI in general, it may be easier to observe some more specific dont's related to FDI promotion. The recent experience of Latin American countries which lured foreign direct investors into privatization programs may offer important lessons in this regard. In various instances, governments conceded (too) much to MNEs that acquired state-owned assets, mainly in the services sector. In Argentina, foreign providers of privatized utilities were relieved from exchange-rate risk by allowing for dollar-denominated charges indexed to inflation in the United States. Brazil enticed FDI into electricity generation by offering gas supplies at subsidized prices. The recent political backlash against privatization in the region appears to be at least partly because such overly generous operation contracts did not prevent MNEs from suspending payments or even leaving Latin American host countries when economic conditions turned sour, as in Argentina in 2002.

This strongly suggests that the regulatory framework should be based on a realistic cost/benefit calculus of privatization-related FDI. In any case, policymakers should refrain from relieving MNEs from business risks such as exchange-rate risk. At the same time, it has to be taken into account that the privatization of services such as water and electricity often amounts to creating a private (local) monopoly. Privatization in such areas requires a strong and permanent public regulator, especially when powerful MNEs are involved.

Similar to the earlier euphoria about privatization-related FDI, the current preoccupation of policymakers with promoting high-tech FDI appears to be out of proportion, once it is taken into account what many developing countries can reasonably expect from FDI in technology intensive industries. This is not to ignore that developing host countries with relatively strong economic fundamentals, notably in terms of complementary local factors of production, may succeed in upgrading FDI inflows through promotional efforts. For example, Costa Rica encourages FDI in high-tech industries by offering skilled human resources in combination with free-zone incentives. Chile targets high-tech FDI in view of its changing comparative advantage, e.g., by subsidizing on-the-job training of workers and providing R&D funds for trade-related activities. Even under favorable conditions, however, the question remains whether potentially positive externalities of FDI outweigh the costs involved in attracting high-tech FDI.

In less developed countries, the current euphoria about high-tech FDI is clearly misplaced. This is for two reasons:[2] First, from the distribution of US FDI in developing countries it appears that the chances to attract FDI in sophisticated manufacturing such as chemicals, machinery and transport equipment are pretty bad for host countries with insufficient schooling and poor institutions. Second, the same host-country characteristics render it fairly unlikely that FDI in machinery and transport equipment results in higher income growth. This is at odds with the hypothesis that a large technological gap between the host country and the home country of FDI fosters FDI-induced catching-up processes in developing countries. Rather, the interplay of host-country characteristics and industry characteristics reveals that positive growth effects of FDI are more likely when the technological gap is relatively small.

As a consequence, before engaging in the competition for high-tech FDI, policymakers in developing countries should undertake a realistic assessment of local capabilities to absorb FDI inflows productively. In many developing countries, policymakers are probably well advised to spend scarce public resources on improving local capabilities, rather than encouraging inflows of high-tech FDI.

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2 For details, see Nunnenkamp and Spatz (2003).

This suggestion is largely in line with the extensive list of policy options, discussed in detail by UNCTAD (2001), of how to create and deepen linkages between affiliates of foreign MNEs and local suppliers, and, thereby, to derive more benefits from FDI. The policy options, summarized in the table below, fall into four broad categories: information and matchmaking, technology upgrading, training, and finance:

- The measures related to the provision of information and matchmaking are fairly standard. They may help overcome information failures and, thus, provide better opportunities for linkage creation between foreign affiliates and local suppliers. However, it is not necessarily governments that have to provide such services; chambers of commerce and industry associations may also assume this role. More importantly, UNCTAD (2001: 175) rightly states that "matchmaking cannot remedy supplier weaknesses".

- Some of the measures going beyond the provision of information are more controversial. This refers in particular to mandatory technology transfers. Apart from being increasingly prohibited through bilateral and plurilateral treaties (see Section 2 above), the effectiveness of technology-transfer requirements is highly questionable (Moran 1998). For example, the much heralded Korean model of technology-transfer requirements was discontinued in the late 1980s already. According to UNCTAD (2001: 194), these requirements were perceived to be a liability: While some MNEs refrained from FDI in Korea altogether, others transferred only out-of-date technologies.

- Most of the other measures listed in the table relate to local capacity building, rather than representing FDI policies in a narrow sense. This is most evident in the case of training. The focus on improving the qualification of the local work force is clearly warranted, in the light of the empirical evidence that favorable growth effects of FDI depend on the availability of sufficiently skilled labor in the host country (Borensztein et al. 1998). Financial measures are mainly thought to ease financial constraints that local suppliers may face in the absence of well-functioning domestic capital markets.

Table — Policy Options for Promoting Linkages

Information and matchmaking	Technology upgrading	Training	Finance
• Handouts and brochures • Electronic databases • Linkage information seminars, exhibitions and missions • Acting as honest broker in negotiations • Supporting supplier audits • Providing advice on subcontracting deals • Sponsoring fairs, missions, etc. • Organizing meetings, visits to plants	• Technology transfer as a performance requirement • Partnership with foreign affiliates • Incentives for R&D cooperation	• Promoting supplier associations • Collaboration with the private sector for one-stop service, including training • Support for private sector training programs • Collaboration with international agencies	• Legal protection against unfair contractual arrangements and other unfair business practices • Legislation and tax measures to shorten payment delays • Guaranteeing the recovery of delayed payments • Tax incentives and other fiscal benefits to firms providing long-term funds to suppliers • Co-financing development programs with the private sector • Providing finance to local firms • Mandatory transfer of funds from foreign affiliates to local suppliers

Source: Adapted from UNCTAD (2001: 210).

In summary, for promoting development-friendly FDI, governments in developing countries must no longer concentrate on narrowly defined FDI policies, many of which are ineffective, or even counterproductive, unless appropriate local conditions are in place.

4. Essential Ingredients of a Broad-based Strategy

For defining and implementing a broader strategy to foster favorable effects of FDI, policymakers in developing countries need to know: (i) the major factors shaping the impact of FDI on host-country development, and (ii) the critical bottlenecks in the country they rule. As concerns the former, the recent literature on the growth effects of FDI in developing countries provides some important insights:[3]

- Better education and training would add to the supply of qualified labor in developing host countries and improve prospects to benefit from technology transfers and spillovers.

- More sophisticated local financial markets enhance the capacity of host countries to absorb FDI inflows. This leads some authors to conclude that developing countries should reform their financial systems before liberalizing the capital account to allow for more FDI inflows.

- Opening up to trade may help become involved in corporate networks and, thereby, to benefit from the widely perceived trend towards efficiency-seeking and export-oriented FDI.

- Institutional development seems to be required to benefit from both efficiency-seeking and market-seeking FDI. Institutional development involves a wide range of fairly time-consuming reforms, including the protection of property rights, control of corruption and efficient administrative regulations.

The crux is that creating a local environment in which FDI is not only profitable for MNEs, but also delivers social returns to the host country by contributing to development objectives, amounts to a daunting task exactly where development needs are most pressing. But even relatively advanced developing countries need a clear understanding of remaining bottlenecks to greater benefits from FDI. A detailed account of competitive strengths and weaknesses

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[3] For an overview and relevant references, see Nunnenkamp (2004).

should provide the basis for defining policy priorities. The World Economic Forum's (2003) *Global Competitiveness Report* offers a reasonable starting point in that regard. This report offers a wealth of indicators related to the policy areas mentioned above, and allows policymakers to identify where their country stands in the ranking of 80 industrialized countries and developing economies.

Policy priorities may differ considerably from country to country. This applies even to countries which, at a first glance, bear close resemblance in terms of attractiveness to FDI, growth performance and overall competitiveness. For example, Brazil appears to be better placed than Mexico with regard to some complementary factors of production, e.g., the innovative capacity of local companies, financial market development and the quality of education (Nunnenkamp 2003). On the other hand, Brazil lags considerably behind Mexico when it comes to openness to trade, which can be regarded as a precondition for becoming involved in international production networks. Hence, Brazil faces different policy challenges, e.g., tackling high costs of importing equipment, than Mexico, where education deserves top priority.

Yet there is one thing that almost all elements of a broad-based strategy have in common: They are time-consuming to implement, and their pay-off in terms of higher and better FDI is unlikely to be visible in the short run. This may explain the preoccupation of many policymakers with narrowly defined FDI policies, notably discretionary incentives. From an economic point of view, however, it is high time to turn the FDI agenda upside down.

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