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Does Foreign Direct Investment Promote Development?

Theodore H. Moran, Edward M. Graham, and Magnus Blomström, editors
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Studies of the linkage between foreign direct investment and development have produced confusing and sometimes contradictory results. Some have shown that foreign direct investment (FDI) spurs economic growth in the host countries; others show no such effect. Some find spillover benefits to the host economy—that is, benefits not appropriated by investors or in the form of superior wages—while others do not discern these benefits. A new book from the Institute for International Economics, *Does Foreign Direct Investment Promote Development?*, seeks to untangle the knotty questions plaguing this field of research and presents new results that show how host countries can maximize the benefits of FDI.

For years, it has been unclear whether developing countries benefit from devoting substantial resources to attracting FDI. A government authority in a developing country might, for example, grant a subsidy to a foreign-invested project if it believed that the project would produce positive externalities or spillovers. These could include managerial and worker training, technological learning that is transferred outside the firm, an increase in supplier efficiency, and demonstration effects through which the success of one investor persuades others to invest in the host country. Yet it has proved extremely difficult to measure such effects.

The book finds that, while recent research tends to point to evidence that spillover benefits do exist, the effects are not universal. One study concludes that the diverse results are due to differences in the host country: varying levels of indigenous human resources, private-sector sophistication, competition, and host-country policies toward trade and investment.

Research has also produced mixed answers to the question of whether FDI fosters economic growth in host countries, depending on which country is studied and which methodology is employed. This book confirms that FDI can have dramatically different impacts, both positive and negative. But it concludes that when increases in FDI in a host country coincide with increases in trade, the host country's economy expands. FDI that is integrated into the global supply network of parent multinationals tends to be particularly potent for host country development, while FDI oriented toward protected domestic markets and hampered by joint venture and domestic content requirements is not beneficial.

Given that FDI produces different results in different host countries, the book offers guidance to policymakers in both developing and developed countries on ways to ensure that FDI aids rather than impedes development:

In countries with protected and distorted economies, FDI is harmful to economic welfare. Where there is little FDI, the harm is little. Where FDI is large, however, the adverse effect on economic welfare is also large. Conversely, in countries with low barriers to trade and few restrictions on operations, foreign firms can increase the efficiency of existing economic activity and introduce new activities with strongly favorable effects on host country development. Consequently, host governments should adopt open trade and investment policies.

Developing country hosts should prohibit domestic content, joint venture, or technology sharing requirements on foreign investment. Such requirements neither increase the efficiency of local producers nor produce host country growth. To the contrary, such provisions interrupt intrafirm trade, which is a potent source of host country growth, and lead to inefficient production processes, outdated technology, and waste of host country resources.

Host countries should avoid competing to give the best tax incentives to foreign investors. Available resources for promoting investment are better spent on improving local infrastructure, the supply of information to investors, and education and training that benefits foreign and local firms alike.

Developed countries should back only FDI that promotes the economic welfare of developing country hosts. Most national political risk insurance agencies do not screen projects to eliminate those that require trade protection. Such FDI hurts rather than helps hosts countries. Neither are taxpayers in developed countries served by FDI projects that lower developing country welfare and impede trade expansion. Thus these agencies should assess the degree to which an FDI project promotes host country welfare as a criterion for agreeing to insure it.

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