Is Foreign Investment Good for Development?

A Literature Review

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The impact of foreign direct investment (FDI) on development is a much debated topic. International financial institutions, such as the World Bank and the IMF, as well as the OECD and its member states, have increasingly promoted FDI because it creates new jobs, spreads best-practice social and environmental standards, and stimulates the transfer of technology, finally leading to economic growth. On the other hand, many NGOs, labour unions and civil society groups have emphasised the negative effects of FDI, illustrated by detailed case studies documenting human rights violations, harmful environmental practices, and tax evasion by Transnational Companies (TNCs) in developing countries. This briefing paper provides an academic literature review on the relationship between FDI and development which may serve as background to the debate on these issues.

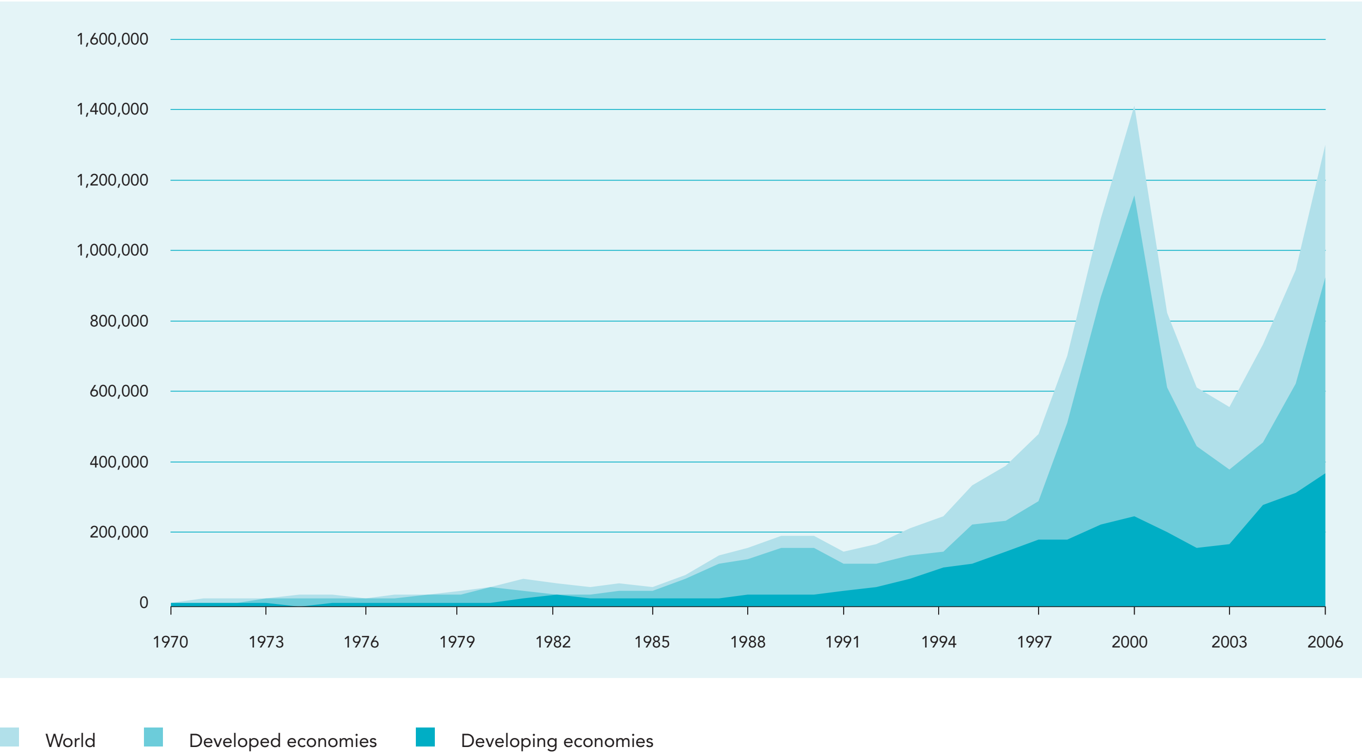
Global FDI trends

FDI are cross-border investments by one firm in another with the intention of gaining a degree of control over that firm's operations. Control is commonly defined as owning 10% or more of the ordinary shares of the foreign company. In contrast, portfolio investment, which refers to ownership shares lower than this percentage, are made predominantly for financial reasons, not to gain control. Within FDI, a further distinction can be made between 'greenfield' investment – investments in new facilities or the expansion of existing facilities – and mergers and acquisitions (M&As) – the transfer of ownership from local firms to foreign companies.

Figure 1 depicts FDI inflows for developing and developed countries as well as the world total for the period 1970-2006. World FDI inflows started to accelerate from the mid 1980s onward from US$ 58 billion in 1985 to an unprecedented level of US$ 1.4 trillion in 2000. The main reason for this peak in FDI was the internationalisation of production and a wave of cross-border M&As. In developing countries M&As were mainly concentrated in newly privatised state-owned businesses, including banks and utilities, such as water, energy and telecommunications. FDI inflows fell steadily from 2001 until 2003, and then started to increase again, reaching US$ 1.3 trillion in 2006. About 70% of World FDI inflows go to the developed countries, while the remaining share is attracted by a handful of developing countries, in particular China, Brazil and Mexico. Africa receives only 2.7% of global FDI (mostly extractives), much lower than any of the other developing regions. Nonetheless, although FDI inflows to most developing countries are small in absolute terms, they make up on average

Figure 1: FDI inflows in the world economy, 1970-2006

Source: UNCTAD, Foreign Direct Investment Online, http://stats.unctad.org/fdi/
Note: Developed countries also include South East Europe and CIS.



14% of total investment and therefore have a significant impact on these economies. Shares in oil-rich countries such as Sudan (65%) and Nigeria (75%) are even higher (UNCTAD, 2007).

The composition of FDI to developing countries across sectors has varied substantially over time and space. During the last decade, FDI has increasingly shifted toward services and away from manufacturing and extractives. However, the increase in mineral prices caused the share of FDI in the primary sector to rise from 7 % in 1989-1991 to 12% in 2003-2005.

Trends in investment policy

An important factor which contributed to the rise in FDI flows to developing countries has been the trend towards FDI-friendly policies. According to UNCTAD (2003) in the 70 countries that liberalised their FDI policies in 2002, 236 of 248 regulations were beneficial to FDI. Developing countries have often been advised and supported by donor countries and international institutions. The World Development Report 2005 found that 26% of all development assistance between 1998 and 2002 went to investment climate improvements, mostly infrastructure development.

At the national level developing countries have:

- Opened up previously closed sectors for foreign investment, often as a conditionality for World Bank or IMF loans.
- Implemented a wide range of policy measures and laws that make it profitable for foreign investors (such as tax holidays, tariff exemptions on imports or exports, free transfer of capital, building of infrastructure), supported by donor incentives such as the World Bank's risk mitigation systems (e.g. MIGA and IFC).
- Created a favourable business climate such as laws that protect (intellectual) property rights, and avoidance of red tape and long or corrupt court cases.
- Set up investment promotion and support agencies, accompanied by donor programmes such as the EU-SADC Investment Promotion Programme.
- Regularly reviewed and renewed incentives and regulations for investors, often based on advise of the Foreign Investment Advisory Service (FIAS) of the World Bank, UNCTAD Investment Policy Reviews, and the OECD 'Policy Framework on Investment'.

At the international level, developing countries have signed a number of agreements in favour of foreign investors, including:

- Free trade agreements and regional investment treaties and (241 in total in 2006), which liberalise investment and eliminate restrictions on foreign investor operations, such as the General Agreement on Trade in Services (GATS) as part of the World Trade Organisation (WTO), and the North American Free Trade Agreement (NAFTA).

- The WTO's Agreement on Trade-Related Investment Measures (TRIMs), which forbids regulations such as local content requirements and restrictions on imports and exports by investors.
- Bilateral Investment Treaties (BITs) which protect investors against government measures that could damage their interests, including by using an international panel for the settlement of investment disputes (ICSID). By 2006 2,573 BITs have been signed, mostly involving developing countries.
- Double tax treaties (2651 in total in 2006) that ensure that foreign investors are not taxed both by the host and the home country.

Most of the investment promotion mechanisms and the investment friendly regulations or treaties are based on the assumption that foreign investors need to be attracted through measures that protect them or provide them with financial benefits. Very few to no instruments or criteria have been built in any of the above mentioned instruments to assess what the impact is on economic development, social development, the environment, and the welfare of the stakeholders such as the labour conditions of the workers.

The relationship between FDI and development: theory

FDI may positively contribute to development in a number of ways. In this paper, development is broadly defined as including economic (economic growth and productivity),

Table 1: Positive and negative effects of FDI

Positive	Negative
Economic impact	
FDI inflow positively contributes to GDP growth through the capital account.	Profit repatriation, royalty and interest payments negatively contribute to GDP growth through the capital account.
Exports by TNCs positively contribute to GDP growth through the current account.	Imports by TNCs negatively contribute to GDP growth through the current account.
Tax payments by TNCs positively contribute to government revenue.	Subsidies, tax incentives, transfer pricing and tax avoidance by TNCs negatively contribute to government revenue.
Knowledge spillovers lead to the diffusion of technology, increasing the productivity of domestic companies	Spillovers are limited because TNCs are 'footloose' or operate in 'enclave' economies. Higher TNC wages lead to a 'brain-drain' from domestic companies.
Entry of TNCs stimulates competition and improves the productivity of domestic competitors.	Lower prices and market power of TNCs causes domestic companies to go out of business.
Backward and forward linkages, and multiplier effects result in crowding in of domestic investment.	Import of machinery and intermediary products by TNCs results in crowding out of domestic suppliers.
Social impact	
FDI induced GDP growth benefits the poor.	FDI induced GDP contraction harms the poor.
Entry of TNCs improves access to, and reduces prices of, (essential) services.	Entry of TNCs deteriorates access to, and increases prices of (essential) services.
Greenfield investment and crowding in of domestic investment creates employment.	Job losses because of rationalisation of companies acquired through M&As, reliance of foreign employees and crowding out of domestic investment.
TNCs pay higher wages than local firms for workers with similar qualifications.	High TNC wages cause inequality because only skilled employees are paid more.
Diffusion of best-practice social standards to domestic companies.	Human and labour rights violations by TNCs. Low wages or temporary contracts in some sectors.
TNCs lobby the government for higher human and labour rights standards and enforcement.	TNCs lobby the government for lower human and labour rights standards and enforcement.
Environmental impact	
Spread of clean production technology and best-practice in environmental management to domestic companies.	Pollution and environmental destruction by TNCs
TNCs lobby the government for higher environmental standards and enforcement.	TNCs lobby the government for lower environmental standards and enforcement. TNCs use investment treaties to challenge environmental laws.

Lessons from history

South Korea and Taiwan are considered to be success stories of industrial development in the post World War Two period. In less than thirty years, both countries managed to increase their per-capita income from a level similar to that of Ghana and Nigeria in 1960 to a level on a par with Spain and Portugal today.

The experience Korea and Taiwan have had with FDI, and how it contributed to economic growth, therefore provides important lessons for today's developing countries. Historical evidence indicates that both countries used extensive controls on foreign investment in terms of ownership, entry and performance requirements, as well as tax incentives to promote spillovers from FDI. For example, the Korean government actively encouraged joint ventures with foreign companies to promote the transfer of technology and management skills, and screened FDI to ensure that the 'right' kind of technology was acquired and that the royalties charged were not too excessive. In Taiwan, investment approvals were only given on the condition that TNCs helped domestic suppliers to upgrade their technology.

Historical evidence indicates that all Western countries, including the USA, Japan and the UK also used similar strategies to benefit from FDI in times of industrialisation.

Source: Chang (2004)

social (poverty reduction, employment creation and human rights) and environmental (pollution and environmental destruction) components. Table 1 summarises the positive and negative impact of FDI.

The mainstream economic argument in favour of FDI-led development is the existence of spillovers. It is argued that domestic companies benefit from the information and knowledge about technology, marketing and management techniques that TNCs bring into the country. Spillovers may occur through various channels, such as the movement of employees from TNCs to domestic companies, the imitation of production technologies and management practices introduced by TNCs and the technical support of TNCs to domestic suppliers.

Conversely, it has been argued that spillover effects are limited in some sectors because these TNCs are 'footloose', and therefore have little incentive to invest in training and education of their workers (in the garment sector, for example), or operate in an 'enclave' setting characterised by limited linkage with the local economy, demonstrated by large numbers of foreign employees and heavy reliance on imports for machinery and intermediate products (in the mining sector, for example).

FDI also contributes to economic growth if it contributes positively to the capital and/or and current account or the sum of both, and government revenues. All of this, however, is dependent on (1) the amount of capital that leaves the country in the form of profit repatriation, royalties and interest payments on intra-company loans, and (2) the balance between FDI imports (such as machinery and intermediate products) and FDI exports, and (3) the balance between tax payments made by TNCs and the subsidies provided by the government to attract them, as well as the extent of transfer pricing – the manipulation of prices of intermediate goods that are traded within the corporate group to avoid taxation.

Finally, FDI may result in the 'crowding in' of domestic investment. Crowding in takes place when TNC presence stimulates domestic investment which otherwise would not have occurred. This happens, for instance, when TNCs purchase intermediates and raw materials from local suppliers or when spillovers lead to the expansion of local firms. On the other hand, FDI can also 'crowd out' investment, when local competitors are driven out of the market.

FDI may also have social and environmental consequences. The main social argument in favour of FDI is that it creates employment, for instance in cases of greenfield investment. On the other hand, there can be limited creation of employment, or even a decrease in employment if local firms are driven out of the market by increased competition, or acquired companies are rationalised after takeovers. In addition, TNCs tend to hire foreign workers rather than domestic labour.

Secondly, foreign investment also impacts on human and labour rights. Proponents have emphasised that TNCs bring best-practice social standards to host countries. In contrast, critics have argued that TNCs engage in a 'race to the bottom' resulting in a deterioration of basic labour rights, such as the prohibition of trade unions and the right to collective bargaining, diminishing working conditions, or even outright violations of human rights.

Table 2: Positive and negative effects of FDI

Developmental impact and indicator	Findings by type of study: Statistical analysis	Findings by type of study: Case study	Source
Economic impact			
Aggregate income	POS, but only when certain variables for 'absorptive' capacity are included in the analysis (e.g. education, financial market development, trade volume and economic development)	POS, historical studies of Western countries and Asian Tiger economies suggest positive effects when combined with industrial policy and government intervention (see box).	Sumner (2005), Chang (2004)
Net capital account	NA	MIX, large variations in share of profit repatriation across regions. Negative contribution to the capital account in case of Unilever Indonesia.	Clay (2005), Sumner (2005)
Net current account	NA	NEG, Negative contribution in case of Unilever Indonesia.	Clay (2005), Sumner (2005)
Government expenditure	NA	POS, positive tax contributions by Unilever Indonesia and Heineken Sierra Leone but anecdotal evidence suggests widespread use of tax avoidance structures by TNCs and proliferating use of tax incentives to attract FDI.	Clay (2003), NCDO (2006) UNCTAD (2003), Pak and Zdanowicz (2002)
Horizontal spillovers/ efficiency of domestic companies	MIX, a review of 17 studies found mixed results for the effect of TNC presence on the performance of domestic companies.	MIX, case studies of Asian Tigers suggest positive effects when combined with industrial policy and government intervention. Other studies find enclave economies with limited spillovers.	Gorg and Greenaway (2004), Amsden and Chu (2003), Gallagher and Zarsky (2007)
Vertical spillovers/ efficiency of domestic companies	POS, one study suggests vertical spillovers between TNCs and Indonesian suppliers.	MIX, case studies provide evidence for both vertical spillovers and enclave economies.	Blalock and Gertler (2007), Gallagher and Zarsky (2007)
Crowding in/crowding out	MIX, available studies indicate that findings depend on type of sector and FDI regime (negative in liberal FDI frameworks) and the strength of local firms.	POS, significant forward and backward linkages in case of Unilever Indonesia and Heineken Sierra Leone.	Clay (2005), NCDO (2006), Sumner (2005), Gallagher and Zarsky (2007)
Social impact			
Income per capita	NEG, recent studies find no causal link.	NA	Sumner (2005).
Income distribution	NEG, most studies suggest a negative relationship between FDI and income per capita but no recent studies available	NEG, Case studies in the water sector suggest that some TNCs undermine access to water by the poor.	Sumner (2005), Beltran (2004).
Wages	MIX, TNCs pay higher wages which increase the welfare of employees and their families but increases wage inequality.between skilled and unskilled workers.	NA	ODI (2002)
Employment	NA	MIX, FDI inflows in Viet Nam have resulted in limited direct employment and minimal or even negative indirect employment. Positive direct and indirect employment effects in case of Unilever Indonesia and Heineken Sierra Leone.	Clay (2005, NCDO (2006), Jenkins (2006)
Labour and human rights	POS, positive correlation between composite basic labour and human rights indicator and FDI – but only one study available.	NEG, case study info on labour and human rights violations by TNCs – but research might be biased towards the study of negative effects only.	Mosley and Uno (2007), Letnes (2002), War on want (2007), De Haan and Vander Stichele (2007)
Environmental impact			
Clean technology	NA	MIX, case studies find the use of both old and new technologies.	Gallagher and Zarsky (2007)
Pollution	MIX, studies have found better, worse and no difference in levels of pollution between TNCs and domestic firms.	MIX, case studies find both good and bad environmental performance of TNCs.	Gallagher and Zarsky (2007), Shell Accountability Coalition (2007)
Environmental regulation	POS, FDI correlates positively with environmental regulation – but only one study available.	NA	Cole et al. (2006)

Note: POS: positive impact; NEG: negative impact; MIX: unclear or mixed impact; NA: not available.

Finally, similar to the diffusion of best-practice human and labour rights standards, it is argued that TNCs diffuse information on clean production technologies to developing countries. In addition, general knowledge spillovers may improve the efficiency of domestic firms, in turn, leading to a reduction in pollution and production of waste. Again, civil society organisations have refuted this argument, referring to case studies of severe pollution and environmental destruction, mostly caused by companies in the extractive and energy sector.

The relationship between FDI and development: evidence

Many studies have tried empirically to determine the impact of FDI on (elements of) development. However, as a consequence of methodological and conceptual problems, statistical analysis has only covered a selected number of issues, mainly focusing on the relationship between FDI and economic factors, such as aggregate income and intra-industry spillovers. In contrast, much less systematic research has been conducted into the social and environmental effect of FDI, and what research has been carried out has relied primarily on casual case-study evidence. Table 2 summarises the findings of the impact of FDI on development.

Conclusions

In theory, FDI may have a positive economic, social and environmental impact on developing countries. In particular, proponents have emphasised that domestic companies may benefit from knowledge spillovers resulting in higher productivity, cleaner production and the diffusion of best practice human and labour rights standards.

On the other hand, there are TNC practices which also give cause to believe that the impact of FDI is only limited or even negative in developing countries as a consequence of crowding out, enclave production characterised by limited forward and backward linkage, and 'race to the bottom' effects particularly related to labour and environmental aspects.

Most mainstream research has been undertaken to identify the economic impact of FDI in developing countries, mainly focussing on the impact on economic growth and productivity through knowledge spillovers. The empirical evidence available provides mixed results and suggests that spillovers do not come automatically or 'for free', but instead suggest that what is needed is active government intervention to 'capture' the benefits, as well as a certain 'absorptive capacity' at the company and country level. So far, only very limited systematic research on the social and environmental consequences has been undertaken, and the results of this research are also mixed.

The empirical findings contradict the national investment promotion policies and the proliferation of trade and investment agreements aimed at the liberalisation of FDI that have been promoted by the World Bank, the IMF and the OECD and its member countries. Under these arrangements, developing countries are severely restrained from using industrial policies or other regulations that have been successfully applied in the past by the Asian Tiger economies and rich Western countries to reap the benefits of foreign investment. Another problem of this set of policies is that they do not take into account the negative social and environmental impact that TNCs could have on developing countries, as demonstrated by numerous NGO reports.

Development can only be facilitated by foreign investment when the right policies are in place. Investment treaties and investment promotion initiatives should not be univocally directed at investment liberalisation and protection, but created with specific social, economic and environmental development targets in mind that need to be regularly assessed and reviewed. In addition, governments should retain (in trade and investment agreements) freedom of regulation and policy, especially to achieve poverty eradication, technology ransfer, respect for human rights and environmental protection. Where enforcement of national labour and environmental laws is lacking, and international standards are not respected, international initiatives to ensure enforcement by TNCs should become part of investment promotion mechanisms. Finally, serious sustainable impact assessments that look into the many aspects of FDI should consistently be applied.

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