FDI as a Source of Finance for Development

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Preface

Mobilising financial resources for economic development has been central to the development strategies of all developing countries. Varied sources of finance have assumed different degrees of significance in the past decades.

The aftermath of the debt crisis of the 1980s saw a huge decline in commercial bank lending to developing countries. Further, official development assistance, though declared as the main source of meeting the external financing needs of developing countries at the Rio Summit in 1992, steadily declined in the nineties. Tying of aid, aid fungibility, improper aid utilisation, failure of ODA to support small and medium-scale development initiatives etc, has led to deep skepticism of its effectiveness in addressing core development needs.

The nineties have seen a greater reliance on private investment, both domestic and foreign, as a source of development finance. 'Direct' foreign investment (FDI), which is normally defined as a 10 percent or more controlling share in a host country enterprise, is by its very definition, perceived to be less volatile than capital market flows such as portfolio investment. FDI is seen to have important implications for a host country's balance of payments, saving-investment and export-import gap and overall macroeconomic management. It is seen as a principal channel for the transfer of technology to developing countries, and through technology spillovers and enhancement of production and export capacities, a boost to economic growth.

Mixed national experiences have shown, however, that there is no strong correlation between the amounts of FDI flowing into developing countries and growth of their economies. FDI has potential benefits for growth and development, the realisation of which depend on a host of factors such as quality and type of FDI, investment climate which includes FDI policies and procedures, infrastructure facilities and other host economy conditions such as growth prospects of the economy and macroeconomic and political stability amongst others.

FDI presents a policy challenge for developing countries. It not only calls for accountability, transparency and efficiency in the corporate investment climate but also for the government to ensure that FDI contributes to development through, for example, regulating FDI and ensuring that the type of FDI that flows in stimulates local industry development.

This monograph is an important contribution to understanding the question: Does turning to FDI put development finance on a more sustainable path?

Jaipur
April 2003

Pradeep S. Mehta
Secretary General

1 Introduction

Unprecedented economic development since World War II notwithstanding, about half of the world's population is living on less than US$2 per day. The international community is increasingly taking notice of this dismal reality. In September 2000, the UN General Assembly adopted the so-called Millennium Declaration. Among the agreed international development goals for 2015, the commitment of governments to halve the incidence of absolute poverty figures prominently.

The mobilisation of financial resources is widely considered an essential means to achieving this goal. The UN Secretary General appointed a high-level panel, chaired by the former Mexican President, Ernesto Zedillo, to recommend strategies for financing economic development of countries plagued by pervasive poverty. The panel's report[1] provided a major input to the UN Conference on Financing for Development in Monterrey, Mexico, in March 2002.

This conference not only seems to have, again, turned the tide in favour of more aid, it was also acknowledged that private financing, notably foreign direct investment (FDI), can provide an important source of finance for development. According to the UN[2], "private international capital flows, particularly foreign direct investment…are vital complements to national and international development efforts. Foreign direct investment contributes toward financing sustained economic growth over the long term. It is especially important for its potential to transfer knowledge and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship and, ultimately, eradicate poverty through economic growth and development." In a similar vein, the OECD[3] reckons that "increasingly, FDI has been recognised as a powerful engine and a major catalyst for achieving development, poverty-reducing growth and global integration process."

The favourable perception of FDI contrasts remarkably with the formerly sceptical, if not hostile, attitude, which prevailed also in UN organisations, towards the activities of multinational corporations in developing countries.

However, some hostility has returned already: globalisation critics consider multinational corporations to be more powerful than nation states, and blame the former for causing still wider income disparities within and between countries.

The public perception of FDI may well take another turn for the worse, if proponents of FDI create unreasonably high expectations in developing countries, by ignoring possible flaws and limitations of FDI and taking its benefits for granted. Against this backdrop, this paper attempts to provide a balanced assessment of the role FDI can play in stimulating economic growth and reducing poverty in developing countries and transition economies. The questions raised are the following:

- What explains the striking change in developing countries' attitudes towards FDI?
- How important is FDI as a source of external financing of developing countries?
- To what extent does FDI contribute to overall capital formation?
- Is FDI going where it is needed most?
- Does empirical evidence support the widely held belief that FDI is a superior source of external financing? More specifically, is FDI more stable than other sources of external financing, are the economic growth effects of FDI higher and, if so, under which circumstances?
- What are the distributional consequences of FDI in developing countries?

The discussion of these questions leads to the conclusion that, in struggling against poverty, the international community should not expect too much from FDI. For poor developing countries, in particular, it appears much more difficult to derive social benefits from FDI than to attract FDI.

2
Why FDI Figures High on the Agenda

Various developing countries and transition economies have opened up to FDI inflows since the mid-1980s. Liberalisation of national FDI frameworks, including relaxation of performance requirements, opening up of previously closed sectors and granting of incentives, has become the dominant type of policy change in these countries. Also, the number of developing countries that have signed bi- or multilateral agreements for investment protection increased dramatically in the 1990s.

The motives for liberalisation are manifold. First of all, policy-makers believed that innovative ways of external financing could compensate for the shortage of more traditional forms of capital imports. In particular, the volume of aid had stagnated in the 1990s and private capital imports, other than FDI, had proved unreliable in episodes of financial turbulence, starting with the Mexican crisis in 1994/95.

By contrast, FDI was increasing and proved less volatile. FDI flows to developing and transition countries increased from 4 percent of these countries' export revenues in 1990 to more than 11 percent in 2000[4] . Furthermore, FDI was expected to offer some unique advantages. FDI is often thought of as a bundle of capital stocks, know-how and technology, and, hence, its impact on growth is expected to be manifold.[5]

Some claim that "FDI is an important – and probably the dominant – channel of international transfer of technology. Multinational enterprises, the main drivers of FDI, are powerful and effective vehicles for disseminating technology from developed to developing countries and are often the only source of new and innovative technologies, which are usually not available in the arm's-length market."[6]

Yet, FDI has its limitations. Limitations may be particularly serious when it comes to poverty alleviation. The unique advantages of FDI over other forms of external financing may materialise only under supportive host-country conditions that are, often, lacking in poor developing countries. Sceptics even argue that the growing importance of FDI in the external financing of developing countries, to which we turn next, bodes developing countries no good (see Box).

Box - The Superiority of FDI: Challenging the Conventional Wisdom

The mainstream view, according to which FDI is superior to other forms of capital imports, has been attacked on several counts by Ricardo Hausmann and some of his former colleagues at the Inter-American Development Bank (for an overview, see the contributions in Braga de Macedo and Iglesias 2001):

- *Growth impact of FDI*: An empirical analysis based on a sample of 43 developing countries in the period 1975-1995 leads to the conclusion that a rise in FDI, in combination with dwindling capital imports of other sorts (which is what we observed in Section 3), is not good for growth. This is because the economic growth impact of FDI is found to be weaker than the growth impact of private debt inflows.
- *Stability of FDI*: FDI may appear more stable than it is. Instead of repatriating FDI, multinational corporations can use other ways to flee a country at the first sign of trouble (e.g., by repaying loans denominated in foreign currency). Hence, the volatility of FDI-related capital flows tends to be underrated, if measurement is restricted to the FDI account and ignores FDI-related outflows showing up elsewhere in the balance of payments.
- *High share of FDI in external financing*: Foreign capital tends to flow to countries that are more developed, more open, more stable, financially better developed and equipped with better institutions. At the same time, all these factors are found to reduce the share of FDI in total external financing. This suggests that interpreting a high FDI share as favourable is unwarranted. Rather, a high FDI share indicates that institutions are deficient and firms need to substitute for missing markets.

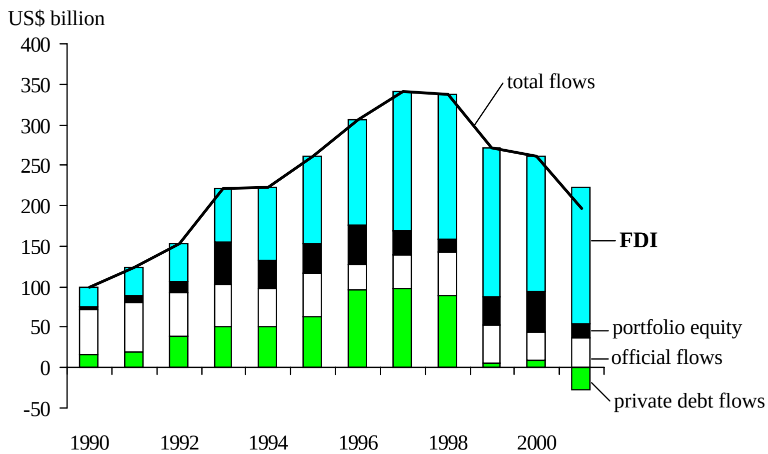
All these arguments are heavily disputed. As concerns the growth impact of FDI, the work of other researchers points to the opposite conclusion. For example, Soto (2000) supports the conventional wisdom that FDI inflows have a stronger impact on economic growth in developing countries than debt-related inflows. The point that multinational corporations may flee a country in various ways is valid in principle, but the empirical relevance of round-tripping of this sort is open to question.

Finally, the finding of a comparatively small FDI share in the external financing of advanced industrial countries is of little relevance for developing countries. Almost by definition, developing countries have weaker institutions and less sophisticated markets than industrial countries. On the (fairly long) road to reaching the development level of advanced economies, it would amount to putting the cart before the horse, if developing countries strived for an external financing structure prevailing in industrial countries.

3
Growing Importance of FDI in External Financing

The structure of long-term external financing of developing countries has changed dramatically since the early 1990s. Figure 1 reveals the dominance of FDI among different sources of external financing in recent years.[7] FDI flows to all developing countries increased steadily in 1990-1999. By contrast, other private capital flows declined sharply in the aftermath of the Asian crisis. This applied particularly to private debt flows. Official net resource flows also became comparatively less important during the nineties.

Figure 1: Composition of Net Resource Flows[a] to Developing Countries, 1990-2001



[a]Excluding short-term debt.

Source: World Bank, Global Development Finance 2002, CD-ROM.

As a result, the share of FDI in external financing of all developing countries more than doubled during the nineties. However, the structure of external financing differs significantly between regions and income groups, though, for all groups, private debt flows contributed, at best, little to capital inflows in 1998-2001 (Table 1). Differences are most pronounced as regards the role of FDI and official (that is governmental) flows. Even though overall aid stagnated, low-income countries, located mainly in Sub-Saharan Africa and South Asia, still depend heavily on official flows; and FDI played a minor role in these countries. By contrast, capital inflows in richer Asian and Latin American countries consisted to 70-80 percent of FDI.

Table 1: Composition of Net Resource Flows[a] to Selected Country Groups, 1998-2001[b] (percent)

	FDI	Portfolio Equity	Private Debt Flows	Official Flows	Total Net Resource Flows (US$bn)
East Asia & Pacific	79.7	27.5	-24.1	16.9	68.9
South Asia	33.2	11.2	11.2	44.4	10.5
Latin America	71.2	4.0	19.4	5.4	107.7
Sub-Saharan Africa	41.3	7.4	-2.9	54.2	20.9
Low-income countries	32.1	6.4	-14.4	75.9	30.3
Middle-income countries	64.2	12.2	15.0	8.6	259.6
All developing countries	65.4	11.2	7.2	16.2	266.5

[a]Excluding short-term debt.— [b]Period average; 1998-2000 for low-income and middle-income groups (missing data for 2001).

Source: World Bank, Global Development Finance 2002, CD-ROM.

The external financing patterns of developing countries have raised two different concerns. On the one hand, some sceptics challenge the conventional wisdom that the high and rising share of FDI in external financing is good news for middle-income countries in Latin America and Asia[8] . The dominance of FDI, accompanied with the scarcity of private debt inflows, may rather reflect weak institutions and deficient markets in developing countries (see also Box).

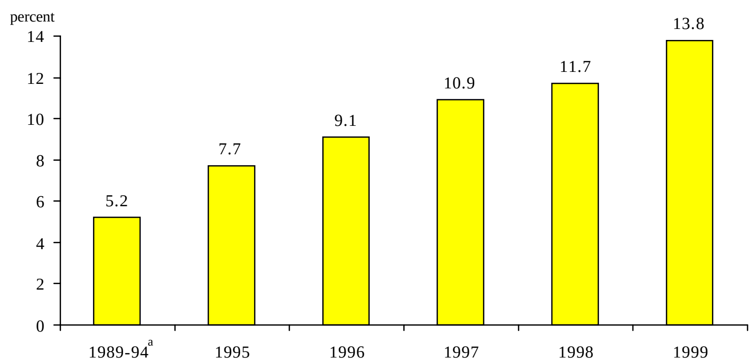
On the other hand, some suggest that FDI can play only a limited role in development financing as "unfortunately, many low-income countries have not benefited from the international investment surge"[9] . The concern that low-income countries are left on the sidelines mainly refers to Sub-Saharan Africa, which is plagued by high incidence of absolute poverty. Studies[10] show that, if current trends continue, poverty reduction in Sub-Saharan Africa will fall grossly short of the international development goal for 2015 to halve the incidence of absolute poverty. Consequently, the UN[11] reckons that the central challenge is to attract FDI to a much larger number of developing countries.

4

Minor Role of FDI in Relation to Domestic Resources

The boom of FDI in developing countries did not only change the structure of external financing but increased the role of FDI in overall capital formation in developing countries. The share of FDI in gross fixed capital formation amounted to about 13 percent in 1998/99, compared to slightly more than 5 percent in 1989-1994 (Figure 2). However, for most developing countries, the mobilisation of domestic resources remains, by far, the most important instrument for financing investment and, thereby, stimulating economic growth. It is, thus, worth recalling from the report of the High-level Panel on Financing for Development[12] : "The primary responsibility for achieving growth and equitable development lies with the developing countries themselves…. The bulk of the saving available for a country's investment will always come from domestic sources, whether the country is large or small, rich or poor."

Figure 2: Contribution of FDI to Gross Fixed Capital Formation in all Developing Countries, 1989-1999



[a]Annual average.

Source: UNCTAD, World Investment Report 2001.

Furthermore, it is hardly possible to establish a clear link between the share of FDI in gross fixed capital formation and the attractiveness of an investment location. Favourable investment conditions should not only induce higher FDI, but should stimulate domestic investment at the same time.[13] As a matter of fact, FDI inflows in 1997-1999 and gross fixed capital formation (both in percent of GDP) are correlated positively in a highly significant way across developing countries, even though the relation between foreign and domestic investment may be blurred by various factors (see Section 6.2 below).

It follows that it is not necessarily a sign of favourable investment conditions, if FDI accounts for a high share in overall investment. For example, exceptionally high FDI shares in countries such as Angola, Azerbaijan, Bolivia and Georgia frequently tend to result from some large FDI projects, motivated by the availability of natural resources (e.g., oil), in combination with a rather poor general investment climate.

Likewise, there is no clear link between a high share of FDI in gross fixed capital formation and a shortage of domestic resources. It is worth noting though, that the four countries just mentioned tend to be constrained in financing domestically large projects in resource extraction. By contrast oil-producing countries with higher per capita income such as Kuwait and the United Arab Emirates, are less dependent on foreign financing for these activities and may, therefore, report lower FDI shares.

Across all developing countries, however, the FDI share is not correlated with the per capita income of recipient countries. This finding has two implications. First, as mentioned before, FDI must not be considered an alternative to domestic resource mobilisation even in poor developing countries. Second, the chances of poor developing countries supplementing domestic resources by attracting FDI may be better than widely suspected. The latter issue is further discussed in the subsequent section.

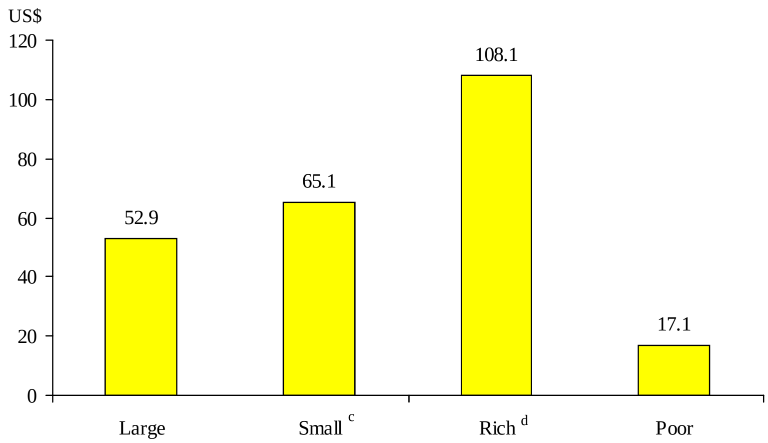
5
Is FDI Flowing Where it is Needed Most?

While it is hardly disputed in the relevant literature that FDI can, at best, complement domestic investment resources, it is more contentious whether all developing countries can actually draw on FDI as a complementary source of financing investment, as FDI is concentrated in a fairly small number of developing countries. For instance, more than 80 percent of inward FDI stocks in all developing and transition economies were located in just 20 countries in 2000[14]. These were either very large (e.g., China, Brazil, Indonesia) or fairly advanced (e.g., Hong Kong, Singapore, Korea, Czech Rep.) economies.

However, if one considers FDI in per capita terms, FDI inflows in 1997-2000 were, on average, higher in small countries than in larger countries (Figure 3). At the same time, per capita FDI flows to rich developing countries (i.e., countries whose per capita income in 1999 was above the median of the overall sample) by far exceeded per capita FDI flows to poor countries. The latter supports the sceptical view that it is typically more difficult for poor countries to attract FDI.

If FDI inflows are related to the recipient countries' GDP, the picture turns out to be more favourable for poor developing countries. Measured by the FDI/GDP ratio, developing countries with low per capita income and high absolute poverty, on average, received almost as much FDI as more advanced developing countries. It must be taken into account, however, that FDI in low-income countries is frequently concentrated in resource-based industries, which may be characterised as foreign-dominated enclaves with weak economic linkages to the local economy of host countries. Economy-wide effects of FDI on productivity and growth may be limited under such conditions.

Figure 3: Per-capita FDI Inflows, 1997-2000[a]: Large versus Small and Rich versus Poor Developing Countries[b]



[a]Annual average.— [b]Countries are considered to be large (small), if their population in 1999 was above (below) the median of 8.0 million for the overall sample; countries are considered to be rich (poor), if their per-capita income (PPP) in 1999 was above (below) the median of 3390 US$.— [c]Excluding Hong Kong and Singapore; if included, average per-capita FDI inflows would increase to 155 US$.— [d]Excluding Hong Kong and Singapore; if included, average per-capita inflows would increase to 209 US$.

Source:UNCTAD, online data base; World Bank, World Development Indicators, CD-ROM.

6

Where the Benefits of FDI Go: Major Issues

Even though the chances of poor and more advanced developing countries attracting FDI may not differ as much as often feared, it is by no means guaranteed that the benefits of FDI are essentially the same in poor and advanced countries. The widely perceived advantages of FDI (see Section 2) may be compromised in several ways in poor developing countries:

- The relative stability of FDI, compared to debt-related capital inflows, may not apply to small countries with low per capita income, in which FDI is frequently restricted to a few FDI projects.
- FDI may crowd out, rather than supplement, domestic investment, if local enterprises lack competitiveness.
- Technological and managerial spillovers from foreign investors to local enterprises may not develop unless the host country has sufficient absorptive capacity, such as skills.
- The economic growth effects of FDI may remain relatively weak in poor developing countries.
- FDI can be expected to benefit more skilled workers in developing countries, thereby worsening the *relative* income position of the poor.

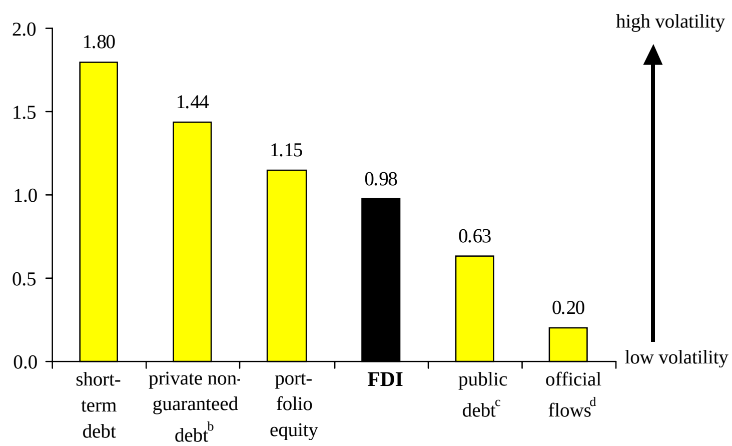
Some of these concerns are of minor relevance, whereas others may severely constrain the role of FDI in financing development where it is needed most, as explained below.

6.1 Volatility of FDI

Various countries in Asia and Latin America witnessed the vagaries of private international capital markets during recent financial crises, which has highlighted the need for less foot-loose external financing. FDI is frequently perceived to provide the solution to this problem, even though the stability of FDI may be overstated due to the possibility of round-tripping (see Box above).

Keeping this qualification in mind, Figure 4 shows FDI to be less volatile than other private (non-guaranteed) capital flow items. Moreover, additional calculations for specific country groups (not shown here) do not support the sceptical view that FDI tends to be less stable in poor developing countries. On average, poor developing countries need not be concerned that their development prospects are compromised by relatively more volatile FDI flows.

Figure 4: Volatile and Stable Capital Flow Items (coefficient of variation[a] for net inflows to all developing countries in 1980-2001)



[a]Standard deviation divided by mean.— [b]Long-term debt.— [c]Long-term; including publicly guaranteed debt from private creditors.— [d]Long-term debt to official creditors (excluding IMF) plus official grants.

Source: World Bank, Global Development Finance 2002, CD-ROM.

Nevertheless, the volatility of FDI varies greatly across countries. Typically, the lower the annual average of FDI flows to a country, the more volatile FDI tends to be. Developing countries in which FDI flows proved highly unstable are concentrated in Africa. The volatility of FDI has a consistently negative impact on growth in developing countries[15]. Consequently, it is mainly in African countries that FDI may have limited effects on economic growth and poverty alleviation.

6.2 FDI and Domestic Investment

As mentioned in Section 4, it does not come as a great surprise that FDI inflows and overall investment in the recipient countries are positively correlated across countries. Foreign and domestic investors alike can be expected to respond to the same favourable economic fundamentals by investing more. A certain bias of FDI against countries in which low domestic investment renders the need for FDI most urgent follows logically.

However, the correlation between FDI and domestic investment is weakened by several factors. Government regulations often prevent foreign and local investors from reacting to economic fundamentals in a similar way. On the one hand, FDI remains restricted in various instances, either generally or in specific sectors reserved for local investors. For example, the regulatory environment helps in explaining why the FDI/GDP ratio of Brazil was almost five times the corresponding ratio in India, although the overall investment ratio hardly differed between these two countries.

On the other hand, local investors are sometimes discriminated against, e.g., when incentives such as tax concessions are available only to foreign investors. A comparison between China, Malaysia and Korea is telling in this regard. While all the three countries reported overall investment ratios which clearly exceeded the average for all developing countries, the FDI/GDP ratios of China and Malaysia were about three times the ratio of Korea. In contrast to Korea, the competition between foreign and private local investors was distorted against the latter in the other two countries; local entrepreneurs in China were politically suppressed until recently and faced serious credit constraints which worked in favour of FDI[16].

Apart from policy-induced distortions, the correlation between foreign and domestic investment depends on whether FDI crowds out local investment. Fears of crowding-out, that is, foreign investors out-competing domestic investors so that the latter invest less, were widespread in developing countries in the past, but may have diminished since several studies have found no evidence to this effect[17]. The predominant view now seems to be that "FDI tends to 'crowd in' domestic investment, as the creation of complementary activities outweighs the displacement of domestic competitors"[18].

However, some warnings may be warranted. Some believe that most of the effect of FDI on economic growth derives from efficiency gains rather than FDI-induced additional investment[19]. In addition, the effects of FDI on domestic investment differ considerably between regions and countries and some studies found that only in Asia is there strong evidence of crowding-in, whereas crowding-out has been the norm in Latin America[20].

For assessing the role of FDI in financing economic development in poor recipient countries, it would be important to know the reasons behind the varying effects of FDI on domestic investment. This is largely unexplored territory, however. Crowding-out may be more likely, if mergers and acquisitions (M&As) are the dominant form of FDI inflows. This could help explain crowding-out in Latin America, where M&As figured much more prominently than in Asia[21]. It may also be suspected that positive investment effects of FDI depend on effective screening, i.e., the government's ability to target FDI projects that do not displace local firms and on the availability of competitive local businesses to promote forward and backward linkages of FDI[22] . Crowding-in may, then, be hampered in poor developing countries lacking administrative capabilities for effective screening of FDI and a competitive business sector. At present, the bottom line seems to be that a positive impact of FDI on domestic investment is not guaranteed.

6.3 Spillovers of FDI and Growth

Similar qualifications apply when it comes to the productivity-increasing effects of FDI in developing countries. As noted before, FDI not only involves the transfer of capital, but is also regarded as a powerful mechanism to transfer technology and know-how to host countries. Yet, it remains open to debate to which extent and under which circumstances FDI-related transfers of technology and know-how result in productivity gains. The significance of spillovers to local firms and workers is crucially important in this regard. Through spillovers, FDI could boost the productivity of all firms, not just the productivity of firms in which foreign investors engage.

Spillovers work through several channels, among which the following three figure most prominently in the relevant literature:[23]

1. **Vertical linkages**: Local suppliers of inputs demanded by multinational corporations and local buyers of products offered by multinational corporations can benefit from transfers of technology and know-how.
2. **Horizontal linkages:** Linkages between foreign and local firms operating in the same industry may promote technological and managerial imitation, as local firms facing fiercer competition can be expected to make use of demonstration effects in order to improve their productivity.
3. **Linkages transferred by workers:** Local firms hiring workers who were previously trained by multinational corporations may benefit from the enhanced skills of these workers.

The relevance of such spillovers is hard to quantify and the evidence from case studies is mixed.[24] As it seems, host country and host industry characteristics determine the impact of FDI. Hence, "systematic differences between countries and industries should be expected. There is strong evidence pointing to the potential for significant spillover benefits from FDI, but also ample evidence indicating that spillovers do not occur automatically."[25] In the present context of FDI as a driving force of economic development in poor countries, it is important to note that the capability of local firms to absorb superior technology and knowledge appears to be a decisive determinant of whether or not the potential for spillovers will be realised.

As a consequence, many poor developing countries may find themselves in a catch 22 situation: FDI-induced spillovers would be required most urgently in poor countries to narrow particularly wide productivity gaps. However, it is exactly the technological backwardness that constrains the poor countries from benefiting from spillovers. Local firms often are too far behind in terms of technological and managerial development for imitating technologies applied by foreign investors or becoming involved as input suppliers. As argued in the remainder of this section, empirical investigations of the economic growth effects of FDI in developing countries add to the concern that the benefits may not go where they are needed most.

The available evidence on the growth impact of FDI remains far from conclusive. First, in contrast to macroeconomic studies, firm-level studies do not lend much support for the view that FDI accelerates overall economic growth[26]. Second, various macroeconomic studies may not be reliable, since they do not control fully for reverse causality (i.e., FDI being the result of, rather than the cause for, higher growth) and country-specific effects. Studies that try to eliminate these potential biases[27] fail to establish a positive influence of FDI on economic growth. It is rather suggested that sound economic policies stimulate growth and, at the same time, provide a favourable climate for FDI.

Third, and most importantly in the present context, even studies drawing a somewhat brighter picture typically reveal that the growth impact of FDI depends on whether or not certain pre-conditions are given in developing countries. Various studies stress different conclusions, such as:

- Openness to trade is essential for reaping positive growth effects of FDI[28].
- The larger the technological gap between the host and the home country of FDI, the smaller the impact FDI will have in the former[29].
- Below a threshold level of financial market development in the host country, FDI will not exert beneficial effects on growth[30].
- FDI raises growth only in countries with a sufficiently qualified labour force[31].

In one way or another, recent studies echo the earlier finding[32] that the positive impact of FDI on economic growth is confined to higher-income developing countries. As it seems, developing countries must have reached a minimum level of economic development before they can capture the growth-enhancing effects of FDI. To put it more bluntly, poverty tends to severely constrain the role FDI can play in eradicating poverty.

6.4 Distributional Effects of FDI in Recipient Countries

Sometimes, it is simply assumed that FDI will contribute to poverty alleviation – an assumption which largely ignores the findings reported in the previous section.[33] Few studies have dealt explicitly with the links between FDI and poverty alleviation. Recent work[34] suggests that a direct link between FDI and poverty reduction does not exist, while three indirect links are considered possible:

(i) FDI-induced increases in national income offer a potential to benefit the poor.

(ii) Well-developed linkages between foreign firms and local suppliers may generate employment opportunities for the poor.

(iii) FDI may lead to higher wages.

As argued above, the former two indirect links are rather unlikely to result in poverty reduction where the incidence of absolute poverty is particularly high. The growth effects of FDI and FDI-induced spillovers are hampered under conditions typically prevailing in the poorest countries. With regard to the third link, critics of globalisation, including representatives of trade unions in industrial countries, blame multinational corporations for paying sub-standard wages to workers in developing countries and forcing them to work under "sweatshop conditions". This seems to imply that FDI in developing countries is adding to, rather than reducing, poverty. However, evidence[35] rather suggests that FDI improves the welfare of workers in developing countries, by increasing the demand for labour and by paying higher wages than prevail locally. This is not to ignore that the wages paid by multinational corporations in developing countries may still be extremely low by the standards of their home countries.

While all workers comparatively benefit from being employed by multinational corporations, relatively skilled workers may benefit significantly more than unskilled workers, who can reasonably be assumed to be poorer than skilled workers. Foreign investors tend to apply more advanced production technologies than local firms operating in the same sector, and FDI is frequently concentrated in relatively skill-intensive sectors (such as resource extraction and sophisticated manufacturing). As a consequence, the labour demand of foreign investors is biased towards higher skills. Not surprisingly, the wage premium paid by multinational corporations in developing countries is larger for skilled workers than for unskilled workers[36] . Moreover, it is questionable that FDI benefits the poorest segment of the population working in the informal sector. Employment in the informal sector may even increase, if foreign investors acquire local firms and shed unqualified labour as a consequence of labour-saving technological progress.

Hence, significant poverty alleviation through FDI-induced wage increases is unlikely, especially in the case of resource-based developing countries with a large informal sector. Harsh critics of FDI often fail to take into account that FDI may lift at least some workers out of absolute poverty, even if the overall income distribution becomes more uneven. On the other hand, it appears to be wishful thinking that higher inequality going along with FDI in developing countries is just a short-term phenomenon. As long as FDI-induced productivity improvements are weak, for the reasons given before, another indirect way of poverty alleviation through drawing on FDI does not offer much relief either: revenues, which the host country's government may derive from taxing foreign investors and use for funding assistance to the poor, will remain limited.[37]

7
Conclusions

For FDI to help achieve the internationally set development goal of halving absolute poverty, two conditions have to be met. First, poor developing countries need to be attractive to foreign investors. Second, the host-country environment in which foreign investors operate must be conducive to favourable FDI effects with regard to overall investment, economic spillovers and income growth.

To a certain extent, these two requirements involve similar challenges for developing countries. The literature on the determinants of FDI suggests that the driving forces of FDI include the development of local markets and institutions, an investment-friendly policy and administrative framework, as well as the availability of complementary factors of production.[38] The discussion in the previous sections provided various indications that these factors would also help ensure favourable effects of FDI in the host countries.

Nonetheless, the two issues should be kept apart. Meeting the first condition, i.e., attracting FDI, is no guarantee for reaping beneficial effects of FDI. Measured as FDI/GDP ratios, developing countries with low per capita income and high absolute poverty received, on average, almost as much FDI as more advanced developing countries. Yet, weak markets and institutions typically prevailing in poor countries may seriously constrain the growth-enhancing effects of FDI. In other words, it appears much more difficult to benefit from FDI than to attract FDI.[39] Resource-based countries with low per capita income frequently exemplify this dilemma. Many of these countries reported fairly high FDI inflows, but the enclave character of FDI renders it unlikely that FDI contributes significantly to economic growth and poverty alleviation.

This leads to the conclusion that the international community is focussing on the wrong question, when, for example, the UN[40] argues that the central challenge is to attract FDI to a much larger number of developing countries. Succeeding in this respect would only solve the minor part of the problem. It cannot simply be assumed that FDI will contribute to poverty reduction, through fostering growth in poor developing countries. The findings reported above suggest that the current euphoria about FDI may give rise to unreasonably high expectations. More FDI in more developing countries might even turn out to be the harbinger of another backlash against multinational corporations, unless the benefits of FDI are widely spread across developing countries.

Another warning may be warranted in this context: “It would be a folly to expect profit-maximising firms, be they foreign or locally owned, to specifically address the development objectives of host countries. They do contribute to development objectives if – and only if – the business environment is conducive to efficiency of operations.”[41] The crux is that creating an environment in which FDI is not only profitable for multinational corporations but also delivers social returns by contributing to development objectives amounts to a daunting task, exactly where development needs are most pressing.

Structural weaknesses impeding technological and managerial spillovers of FDI are difficult to overcome. Attempts by various developing countries to compensate for the lack of market-driven linkages between foreign and domestic firms, by imposing local-content requirements and technology-sharing requirements on multinational corporations, often proved “harmful – actually damaging – to the growth and welfare of the developing countries”[42]. For multinational corporations to accept such performance requirements, they were frequently offered protection from local and foreign competition as a quid pro quo. Incentives for productivity increases were weakened in this way.

A similar dilemma is involved when foreign investors are granted tax incentives or outright subsidies. In principle, special incentives may be justified, to the extent that FDI results in spillovers, in order to bridge the gap between the private and social returns of FDI[43]. However, it is far from obvious that FDI incentives are cost-efficient, once it is taken into account that spillovers do not occur automatically. Moreover, the discrimination of domestic investors resulting from FDI incentives tends to discourage domestic resource mobilisation, which clearly represents the most important source of financing economic development.

In the absence of a quick-fix for deriving more benefits from FDI, poor developing countries are well-advised not to expect too much from FDI. For various countries, it may take considerable time to reach the minimum level of economic development, which, according to the available evidence, seems to be required for FDI to provide a strong catalyst for growth. The international community should be aware that FDI falls grossly short of providing an easy solution to the most pressing development problem, i.e., the disturbingly high incidence of absolute poverty in many developing countries.

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Endnotes

1 UN 2001

2 Un 2002a: 5

3 OECD 2002

4 UNCTAD, online data base

5 de Mello 1997: 1

6 JBIC Institute (2002: 1)

7 We refer to net resource flows in the following. This means that principal repayments are subtracted from gross disbursements of external finance. However, interest payments are included in net flows. Excluding interest payments results in net transfers.

8 Hausmann and Fernández-Arias 2001

9 OECD 2002

10 Collier and Dollar (2001)

11 UN 2002b: 5

12 UN 2001: 3 f

13 This is why Hiemenz et al. (1991: 5) regard FDI inflows and the overall investment ratio as two complementary proxies for measuring international competitiveness. These authors argue that the former proxy reflects the international dimension of capital mobility, while the latter proxy reflects the intertemporal dimension of capital mobility.

14 UNCTAD online data base

15 Lensink and Morrissey (2001)

16 IMF 2002

17 Lipsey 2000

18 JBIC Institute 2002: viii

19 Borensztein et al. (1998: 128)

20 Agosin and Mayer (2000)

21 JBIC Institute 2002: 19; Nunnenkamp 2002a

22 Agosin and Mayer 2000

23 See JBIC Institute (2002) for an informative survey.

24 For a detailed review of the evidence, see Blomström et al. (2000)

25 Kokko (2002)

26 Carkovic and Levine 2002

27 Carkovic and Levine (2002)

28 Balasubramanyam et al. (1996)

29 De Mello (1997)

30 Alfaro et al. (2001)

31 Borensztein et al. (1998)

32 Blomström et al. (1994)

33 For an example of an overly simplistic view, see Klein et al. (2002).

34 For a summary, see Overseas Development Institute (2002)

35 Overseas Development Institute (2002), Graham (2000);

36 Overseas Development Institute 2002

37 In addition, it is not guaranteed that tax revenues would actually be spent to serve poverty-alleviating purposes.

38 The determinants of FDI have not been discussed in any detail in this paper. For an overview, see Nunnenkamp (2002b) and the literature given there.

39 Balasubramanyam (2002: 194) comes to a similar conclusion: "High volumes of FDI alone do not contribute to the social product. Needless to say, the contribution of FDI to growth and development objectives, including dissemination of technology and know-how, promotion of trade, and employment creation, is conditional upon its efficient utilisation."

40 2002b: 5

41 Balasubramanyam 2002: 199

42 Moran 1999: 45

43 Kokko 2002

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