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How is FDI Related to Economic Development?

Introduction

The UNCTAD has predicted that China will overtake USA as the highest foreign direct investment (FDI) recipient of the world in 2002: the first time that a developing country would be the winner in the FDI race. China's spectacular success in experiencing a high FDI inflow and economic growth has left the world agape. Big developing countries, such as India and Brazil, have been hoping that they can move closer to the Chinese FDI levels by taking effective measures to attract FDI. Smaller countries have been attempting to draw as much FDI as they can. Global FDI flows have also increased rapidly in recent years, overtaking global overseas development assistance (ODA) flows since the late 1990s.

It is not surprising that there is a lot of hype surrounding FDI. Arguments and counter-arguments about FDI and its relationship with development can take highly polarised positions. A number of studies have been conducted on the relationship between FDI and development. The studies conclude that FDI can have beneficial effects on a host economy if right policies and regulatory conditions are in place.

This paper examines whether the positive impact of FDI on development in a country depends on the quality of FDI it is receiving. It also looks at the global FDI trend, which is important to understand the debate on FDI and development. The paper discusses the benefits developing countries expect from FDI, while pointing out the fact that countries compete with each other for FDI. It argues that a strategy to facilitate favourable effects of FDI on development will be the one that promotes overall economic development in the country. Otherwise, the country may suffer from mal-development. Lastly, the paper outlines some measures to maximise benefits from FDI and looks very briefly at the debate whether FDI follows development.

Is "Quality" Important?

One of the factors said to be bringing about contrasting impacts of FDI on economic development in different countries is the quality of FDI they have been receiving. Nagesh Kumar, in "Globalisation and the Quality of Foreign Direct Investment", argues "the literature has, however, tended to treat FDI as a homogeneous resource benefiting the recipients in the same manner and neglected any potential differences in the quality of FDI received". Kumar argues that the quality of FDI can be determined by how much the foreign affiliates have linkages with the economy (See Box I). How much a country would benefit from FDI depends on the quality and quantity of FDI and the domestic economic environment, e.g., whether and how the benefits are distributed among the people.

T.H. Moran in "Foreign Direct Investment and Development", however, argues that the attempts to achieve localisation of affiliates' output, by imposing domestic content requirements, can be extremely costly for host developing countries and can also be ineffective. This is because, he says, except for big economies, economies of scale are not fully realised in host developing countries.

Box I: The Determinants of the "Quality" of FDI

The quality of FDI can be determined by:

- The extent of localisation of affiliates' output: how much linkage foreign affiliates have with the local economy;
- Its contribution to the development of modern industries: foreign affiliates entering into relatively technology-intensive industries, which are new to the host country, bring more benefits;
- Its extent of export-orientation: FDI in export-oriented units can have substantial balance of payments benefits and positive external effects; or
- Research and development (R&D) activity of affiliates: such activities have substantial positive externalities.

Source: Nagesh Kumar, Globalisation and the Quality of Foreign Direct Investment

Where is FDI Flowing?

FDI inflows and outflows slowed down in 2001, after reaching a peak in 2000[1]. The slowdown is more pronounced in developed countries than developing countries, but most FDI still flows between developed countries. The United States was the world's largest FDI recipient and investor in 2001, followed by the European Union. Developing countries received lesser FDI in this year (US$205bn) than in 2000 (US$238bn). Most of the decline of FDI to developing countries was concentrated on a smaller number of host developing countries, particularly Argentina, Brazil, Hong Kong and China.

Regarding the regional performance of developing countries, Asia has been the most important host region and the importance of Latin America has declined over the last few years. Africa is still a marginal recipient, though it received higher FDI in 2001 (US$17bn) compared to 2000 (US$9bn). This, however, was mainly on account of some large projects in South Africa and Morocco. FDI inflows were stagnant in North-East and South-East Asia but increased in South and Central Asia in 2001 over 2000. Inflows into Latin

America and the Caribbean slowed down for the second consecutive year in 2001.

The share of developing countries in world FDI inflows was lower in 1999-2000 than in 1991-98, but increased in 2001. Their share increased from 17.9 percent in 2000 to 27.9 percent in 2001, whereas the developed countries' share decreased from 80.0 to 68.4 percent in the same period. Central and Eastern Europe attracted 3.7 percent of the world flows in 2001 (compared to 2.0 percent in 2000) and least developed countries attracted 0.5 percent (0.4 percent) in the same year.

Potential Benefits

Countries seek FDI because of its potential benefits. The most often cited benefit of FDI is that it can supplement a shortfall in domestic savings. Countries, which do not have a domestic resource crunch, may seek FDI for other potential benefits (See Box II).

The potential benefits of FDI can be classified into benefits through trade and through non-trade channels[2]. Traditional theory states that FDI substitutes trade, while empirical analyses show that the former complements the latter. If a company decides to set up a unit in a country to which it used to export, FDI substitutes trade. If local affiliates of foreign companies import inputs to manufacture products for domestic and international markets, then FDI complements trade. FDI can stimulate exports, if the motive of foreign investors is to exploit the export potential of the country. FDI usually stimulates exports in the natural resources sector. Transnational corporations (TNCs), such as mining and oil companies, play a leading role in this.

Non-trade benefits flow from the fact that TNCs possess assets such as advanced technology, managerial know-how, skills, international production networks, brand names and access to international markets, which are not easily obtainable by developing countries. These resources are not easily obtained in the market. One way to obtain them is by letting FDI enter a country. These factors help in the modernisation of an economy, increase productivity and bring about high economic growth[3].

Box II: Potential Benefits of FDI

- Establish backward and forward linkages with the rest of the economy;
- Provide access to advanced technologies and facilitate the transfer of technologies;
- Bring in improved management practices;
- Expand and diversify the production capacity of an economy;
- Transfer best practices in corporate governance and accounting practices;
- Integrate the domestic economy with the global economy and infuse competition in the domestic economy; and
- Relatively stable than other forms of international capital flows as it has a longer-term perspective

Source: CUTS

Competition among Countries

For the benefits described above, developing, as well developed countries, compete fiercely for FDI. They try to attract foreign investors by providing financial and fiscal incentives, undertaking corporate restructuring and economic reforms and inviting foreign investors in the privatisation of state-run units. In 2001, for example, 71 countries made 208 changes in their FDI regulatory regimes, out of which 194 were done to attract higher FDI[4].

FDI is one of the means of achieving the targets of higher economic growth and development. When countries try to attract FDI for their own sakes, they may overlook negative effects of certain types of FDI, such as adverse environmental effects of extractive industries. In an industry such, as petroleum exploration, refining and distribution, which is highly environmentally sensitive, the major businesses are transnational companies. There are allegations that many of these companies do not follow proper environmental practices in several least developed countries and that many of these countries overlook environmental hazards posed by the companies.

FDI, which brings in environmentally harmful technologies, may do more harm than good to a country. It is alleged that similar other threats posed by foreign companies, such as displacing domestic investment or creating economic and social inequalities, are ignored by host developing countries. It is necessary for countries to adopt strategies to attract "quality" FDI and maximise benefits from it. However, it could be the other way round, domestic companies may have poorer performance than the foreign ones in social and economic terms. Therefore, countries should regulate foreign as well as domestic investment.

Needed: An Effective Development Strategy

The aim of attracting FDI should fit into a country's overall development strategy. It is also necessary to encourage domestic investment, along with FDI, in a country to increase its total investment[5]. East and South East Asian (ESEA) countries, which are said to have experienced a favourable effect of FDI on economic development, took steps to increase domestic as well as foreign investment. Further, foreign companies may be reluctant to invest in an economy, if domestic investors are reluctant. For example, it is said foreign investors prefer not to invest in South Africa because investment by domestic investors is very low, even though domestic investors have adequate resources[6].

Regulation of foreign, as well as domestic, investment is another major element in the development strategy of any developing country. The motive of any company, domestic or foreign, making investment is to make profits. Countries have to make sure that the profit-making activities of the companies do not clash with their overall development strategies, by regulating both domestic and foreign investment.

FDI, however, is neither a necessary nor sufficient condition for economic growth and development: higher FDI may not imply faster economic development. A lot depends on the strategies a country adopts to attract FDI. East and South East Asian countries, for example, have utilised FDI to stimulate economic growth by taking a selective and strategic approach to FDI.

South Korea and Taiwan, for example, did not receive very high FDI, as they had imposed restrictions on entry of FDI and the degree of ownership. The two countries, however, took steps to maximise the spillover effects of FDI by encouraging FDI, accompanied with certain kinds of technology, imposing strict local content requirements and encouraging investors, such as sub-contractors, who were willing to transfer technology to domestic companies. China, Malaysia and Singapore, in contrast, had greater FDI flows but did make sure that they receive FDI in line with their national development priorities[7].

There are, however, other countries, which imposed local content requirements, such as Brazil, that had imposed such requirements in high technology sectors but were not much successful in benefiting from FDI. ESEA countries might have been able to benefit from FDI, by imposing local content requirements because of the accompanying high economic growth. In this context, the question is, whether FDI benefits growth or growth benefits FDI.

Can FDI Cause "Mal-development"?

It is often alleged that FDI causes "mal-development" by impoverishing developing countries: it increases poverty in the countries. The potential costs of FDI are:

1. Negative impact on balance of payments (increases balance of payments deficit), if it increases imports of raw materials and inputs and remittances of royalties and dividends;
2. Leads to inaccurate transfer pricing, if the products, which are imported by foreign affiliates from parent companies, are overvalued and the exports to the parent company are undervalued. This may also lead to balance of payments deficit;
3. May reduce domestic investment or replace domestic monopolies by foreign companies.[8] This leads to unemployment; and
4. May transfer outdated or environmentally harmful technologies.

FDI can harm a country through the same route by which it can benefit the country. If trade effects of FDI are considered, balance of payments crisis can be caused if foreign investors import more than they export. Further, TNCs with a large size and market power may hinder proper development of domestic markets. Moreover, FDI may be costlier than other means of acquiring the factors, such as advanced technology and managerial practices. It may be cheaper for a country to develop these domestically[9]. If a country has the potential to develop its domestic resources, then a better way of utilising FDI could be to strategise the role FDI can play in the development of domestic resources rather than depending on FDI to acquire technology and other resources.

There is, however, no evidence to show that FDI has a negative impact on poverty reduction. It may have an indirect effect on poverty, if it leads to higher economic growth and employment. However, there is a weak link between an increase in economic growth and a reduction in economic inequality and poverty. Traditionally, it is thought that growth is important for reducing absolute poverty, though higher growth may not reduce poverty. On one the hand, several countries in Latin America have experienced increases in FDI and economic growth and an increase in inequality at the same time. On the other, ESEA countries have experienced simultaneous increases in FDI and economic growth and decreases in economic inequality and poverty over the past two decades.

By itself, FDI is unlikely to make much of a dent in the poverty situation. Government-initiated programmes, which improve social safety nets and redistribute income and profits, complementing its policies, have proved to be more useful for this. FDI-led higher economic growth can provide funds for such programmes. FDI can also help in the provision of social services, such as delivery of water and power, especially in countries where the state has failed to provide such services adequately. Proper regulation of FDI in these sectors is usually necessary to ensure that the poor have proper access to the services. In recent times, Peru and Bolivia have had unpleasant experiences with the privatisation of the water sector.

In the World Trade Organisation (WTO), there have been proposals on having agreements to liberalise public services, such as water delivery, power, health care, primary education and postal services, under the General Agreement in Trade in Services (GATS). However it is feared that if public services are liberalised, TNCs would enter these sectors in developing countries and deprive a large number of poor people from the services by charging high prices. It is important, they point out, that developing countries study the impact of the entry of foreign investors in these sectors before they make any such commitments at the WTO.

There are also concerns that FDI, mainly TNCs, drains resources from developing countries and is a new form of economic imperialism. Many in developing countries fear that FDI flows will be followed by developed countries taking over of their countries. FDI policies of several developing countries, such as India, were moulded by this belief- the “East India Company syndrome”, for a long time. India, now, officially welcomes FDI and has been taking policies and measures to attract FDI. In today’s information age, it might be difficult for a company to do a repeat of what the East India Company did in India. The global political, social and economic conditions have changed beyond recognition in the last 50 years. It might be fanciful to compare foreign capital that had entered developing countries, say, about a hundred years back with today’s FDI flows.

It is, however, important to weigh the costs and the benefits of FDI to gauge whether FDI has a positive impact on economic development.

How to Maximise the Benefits?

The relative strengths of the costs and the benefits of FDI depend on whether the economy has a sound investment climate. An investment environment is said to be a sound one if the country has the following[10]:

1. A sound macroeconomic environment, which depends on monetary and fiscal policies and conditions such as stability of interest rates and status of fiscal accounts;
2. Appropriate institutions, which depend on the existence of effective legal and regulatory structures, a competition authority and investment promotion and facilitation institutions; and
3. Adequate basic infrastructure, which implies adequate supplies of power, water, land, transport and communications.

It can be said that these factors are the “right conditions” to ensure that FDI has beneficial effects on the economy. There is, however, no single winning formula for maximising benefits from FDI, in that there is no single set of right conditions for all countries. For example, several countries have managed to benefit from FDI without the presence of a competition authority.

A sound investment environment is needed to establish linkage with the rest of the economy. If a country lacks basic infrastructure, linkages of FDI with the rest of the economy might not be established and the country, most likely, would not benefit from FDI. Countries such as Angola and Nigeria attract FDI in sectors such as mining and petroleum, but they lack good infrastructure. Consequently, FDI has not been bringing benefits to large segments of population in these economies. While all the “right conditions” need not be present in countries, which open up their regimes to attract FDI, it is usually believed that some of the basic conditions should be present. It is said that a number of African countries did not benefit from FDI because they opened up their economies to foreign investors without the accompanying economic, institutional or infrastructural reforms.

Small developing economies should be cautious, as they have less FDI absorptive capacities than the larger ones. Though absorptive capacities are difficult to define, a sudden surge of FDI can be harmful for small economies and lead to balance of payments crisis[11].

What Comes First: FDI or Development?

When discussing the effect of FDI on economic development, it would be interesting to look into the debate that FDI follows development. Debate is going on in countries such as South Africa on whether growth and development follows FDI, or is it the other way round. Some studies say that a country should achieve a certain level of economic and institutional development before it can benefit from FDI[12]. FDI, reportedly, has had a more favourable effect on economic development in more advanced developing countries than poorer developing countries.

It is said that economic and structural reforms undertaken in ESEA economies have facilitated FDI. Their experience

suggests that FDI depends on the availability of adequate infrastructure, appropriate labour, per capita income and economic growth of a country. It is also said that these countries were able to achieve high economic growth because of high FDI flows. FDI and development, it seems from the evidence, have a symbiotic relationship. One induces the other and vice versa. Therefore, an effective development strategy for developing countries would be to undertake measures for economic reforms and governance as well as to FDI at the same time.

A curious case is that of South Africa. It is said that its capital markets are well-developed so that the foreign companies can raise capital from the domestic market any time and does not need to borrow from elsewhere. As noted earlier, the country's investment, both domestic and foreign, is low. The explanation given for the country's low investment is that since the country's savings exceeds its fixed investment, it does not need new investment.

Conclusion

It is difficult to predict whether FDI will promote economic development, but it can be said that if FDI adds to the productive capacity of the economy, for example when it uses local resources, it is beneficial for the country. The country would likely to benefit if such use of resources is market-driven. If it is policy-driven, there could be distortions outweighing benefits of FDI. Often, companies establish units in a country, import semi-processed goods and export finished goods, which is likely to add very little value to the country's productive capacity. Further, development benefits of FDI in a small country also depend on a country's absorptive capacity. This is especially true for small developing countries, which are small players in the global trade.

A country can lose from FDI through the same routes by which it can benefit from FDI. It should take measures to improve its investment environment before liberalising its FDI regime to allow more foreign investors. FDI would have a positive effect on development, if a country is able to make sure that it has adopted measures, which would maximise benefits from FDI. At the least, a country should adopt minimum regulatory measures to ensure that FDI or domestic investment does not harm its economy.

The mixed impact of FDI on development notwithstanding, countries compete fiercely among themselves for FDI. However, they might not compete for the same FDI projects. Even though developed countries are still the highest FDI recipients, developing countries provide large-scale incentives to attract FDI. Studies, however, indicate that incentives do not attract FDI to a country. Furthermore, countries may end up hurting themselves by providing incentives, if the costs of incentives are greater than benefits.

Another pitfall of the FDI competition is that often FDI is wanted just for its own sake. Developing countries sometimes do not strategise effectively about the desired use of FDI, the sectors that should receive FDI and that FDI fits into their overall development goal.

Given below is a summary of the measures that could be taken to improve the investment climate of developing countries:

1. Define the country's development priorities first and then channelise FDI accordingly;
2. Implement poverty reduction and income redistribution measures along with FDI liberalisation measures;
3. Put in place a regulatory structure to prevent any corporate mal-practices;
4. Promote FDI with the potential of having deep linkages with the local economy;
5. Develop an investment environment, which ensures that benefits of FDI outweigh costs;
6. Being cautious as to not to open up the economy to allow more FDI than that it can absorb;
7. Disseminate information and build the capacity of its citizens on the various aspects of FDI and development; and
8. Conduct research and outline a clear country position on FDI before committing themselves to any agreement relating to investment at the WTO.

Endnotes

1 UNCTAD World Investment Report 2002
2 UNCTAD Issue Paper series, "FDI and Development"
3 OECD Global Forum on International Investment: New Horizons for Foreign Direct Investment
4 UNCTAD World Investment Report 2002
5 More specifically so that gross domestic capital formation takes place
6 South Africa, Investment Policy Report
7 Foreign Direct Investment, Development and the New Global Economic Order-A Policy Brief for the South
8 At best FDI may fail to contribute to gross domestic capital formation (GDCF) and at worst it may reduce GDCF
9 Alternatively, it may be very expensive for developing countries to develop these domestically
10 World Bank World Development Report 2002
11 UNCTAD Issue Paper series, "FDI and Development"
12 Why the Case for a Multilateral Agreement on Investment is Weak, Peter Nunnenkamp & Manoj Pant

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