

# **Foreign Direct Investment and Development**

## *An historical perspective*

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Background paper for  
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## Abstract

The role of investment, especially foreign direct investment (FDI), in driving economic growth and development has been a contested one ever since the UN development decade of the 1960s. There have always been views in favour of FDI and against it. Some argue that FDI leads to economic growth and productivity increases in the economy as a whole and hence contributes to differences in economic growth and development performances across countries, but others stress the risk of FDI destroying local capabilities and extracting natural resources without adequately compensating poor countries. This paper examines trends in the relationship between FDI and development in an historical context.

One important, albeit insufficient indicator of FDI induced growth, is the *level* of FDI. Not surprisingly, the level of FDI and relative importance of FDI in national economies have fluctuated over time and differed markedly across countries. Both measures were high in the early part of the 20<sup>th</sup> century, low in the middle part and growing and high towards the end. Recently there has been an increase in FDI to developing countries, with variations across regions and countries. Inward FDI to developing countries has always been concentrated in a handful of countries, in part reflecting their economic wealth and policy barriers. However, the determinants of FDI and hence FDI induced growth prospects have changed over time. While policy barriers to trade and investment have affected the attraction of FDI in many countries for long periods of time, FDI is increasingly looking for “sticky” places in the web of global production processes, and thus in need of good economic fundamentals such as market size and growth, good quality and appropriate skills and infrastructure, and local technological capabilities.

A major change over the past three decades has been that governments have become more favourable towards FDI, and have liberalized their FDI regime accordingly, though at different times, speeds and depths in different countries and regions. Over the past fifteen years, countries have regarded FDI increasingly as contributing to their development strategies for the technology and capital it provides. They have even have started to compete for FDI. Investment policies have become more liberal at the national and regional level, but there is no comprehensive framework at the multilateral level. Some home countries are also increasingly facilitating FDI into developing countries using guarantee funds, matchmaking and other measures.

However, at the same time as countries have begun to realise the positive aspects of FDI, a more nuanced view on FDI and development has now emerged in the research community, viewing the impact of FDI on economic growth as not only positive or only negative (the volume of FDI is not a sufficient indicator for growth prospects), but that the effects depend on the type of FDI, firm characteristics, economic conditions and policies. For example, the type and motivation of FDI is important: an increase in efficiency seeking FDI in high value added manufacturing has been instrumental in transforming production structures in several East Asian countries since 1960s and hence their growth performance, while the same cannot be said for natural resource seeking FDI in certain weakly governed oil rich developing countries (e.g. Nigeria in the 1970s - 1990s), or market seeking FDI that replaces local domestic capabilities in import substitution countries in Latin America in the 1970s and early 1980s.

The type and sequencing of *general and specific policies* in areas covering investment, trade, innovation and human resources are now seen as crucial in affecting the link between FDI and development. While FDI is often superior in terms of capital and technology, spillovers to local economic development is not automatic. Appropriate policies to benefit from FDI include building up local human resource and technological capabilities to raise the absorptive capacity to capture productivity spillovers from Transnational Corporations (policies similar to those that try to attract FDI in the first place). Countries have used general policies (improving the investment climate) and specific policies (linkages programme, tailored human resource development) to make FDI work for development. All in all, there has been a marked shift towards liberalisation of the FDI regime, and FDI is regarded more favourably now than a couple of decades ago, but also governments increasingly realize that policies can influence the effects of FDI on development.

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# 1 Introduction<sup>1</sup>

The WESS2006 seeks to explain the role that FDI plays in explaining divergences in economic growth and development performance over the period since the first UN Development Decade in the 1960s. This role has been a contested one (see e.g. Fredriksson and Zimny, 2004). From the 1960s onwards there have been voices in favour of FDI and against it. Some argue that FDI leads to economic growth and productivity increases in economy as a whole, but others stress the risks associated with FDI. This paper provides a brief survey of the evolving state of knowledge about the FDI-development nexus.

FDI used to be viewed as unhelpful, negative and bringing inappropriate technology to developing countries. More than four decades on, a radically different view from the beginning of the period has emerged. FDI is now seen as beneficial and nearly all countries try to provide a welcoming climate for investment. Countries increasingly recognise that they can affect the attraction of FDI using both general economic policies and appropriate specific FDI policies.

However, at the same time as country governments have begun to realise the positive aspects of FDI, a more nuanced view on FDI and development has now emerged in the research community, which views the impact of FDI on economic growth as not only positive or negative, but that the effects depend on the type of FDI, firm characteristics, economic conditions and policies. The type and sequencing of *general and specific policies* in areas covering investment, trade, innovation and human resources are now seen as crucial in affecting the link between FDI and development. While FDI is often superior in terms of capital and technology, spillovers to local economic development is not automatic. Appropriate policies to benefit from FDI include building up local human resource and technological capabilities to raise the absorptive capacity to capture productivity spillovers from Transnational Corporations (TNCs).

The structure of this paper is as follows. Section 2 provides background information about macro trends in FDI and how trends have differed by region and country. It is important to discuss trends in FDI as some countries have attracted more FDI and will therefore have greater potential to use FDI for their benefit. However, the quantity of FDI is not sufficient to safeguard a beneficial impact. One factor influencing this is the type and motivation of FDI. Therefore, section 3 discusses the evolution of determinants of FDI, from market-seeking and tariff-jumping FDI towards efficiency-seeking FDI attracted to created assets such as human resources and infrastructure. Policy is another crucial factor in influencing the link between FDI and development, as we discuss in the main section, 4, discussing the impact of FDI. Most governments are increasingly regarding FDI as beneficial and have begun to realise that effective FDI policies can help to maximize the benefits from FDI and minimize the costs of FDI. Section 5 confirms the overall trend towards FDI policy liberalization with an overview of FDI policy developments and their effects. Section 6 concludes.

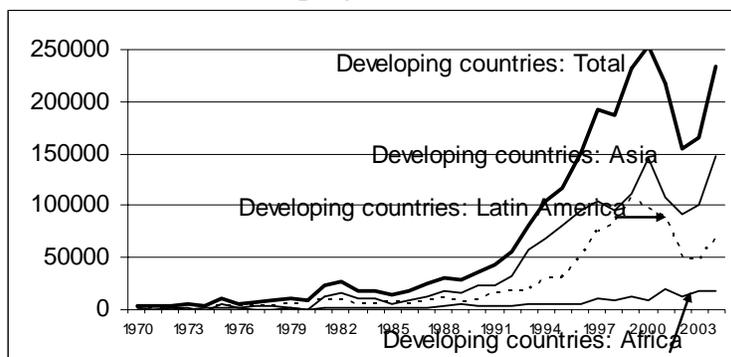
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<sup>1</sup> I am very grateful to Torbjorn Fredriksson and Hafiz Mirza for their very helpful comments and suggestions on an earlier version.

## 2 Trends in FDI

The level and composition of FDI has changed markedly over time and this has implications for how FDI affects development, not least because countries with increased amounts of the right type of FDI will have a bigger potential to benefit. This section presents FDI data in an historical perspective. There has been a rapid increase in FDI in the past two decades, with a decrease more recently for developed countries, though with differences across countries (chart 1).

**Chart 1 Inward FDI to developing countries, 1970–2004, million of USD**



Source: UNCTAD

Table 1 shows FDI data for 1913–1995 as published by Twomey (2000) and updated to 2004 using UNCTAD data. It is clear that inward and outward FDI, measured as the stock in relation to income, has fluctuated throughout the 20<sup>th</sup> century. There has been a rapid increase in outward FDI over the past four decades, but in most cases relative to GDP, outward FDI was in 1995 still below what it was at the beginning of the century. Similarly, inward FDI to developing countries was high in the first part of the century (due to FDI in railways) and then dropped. The latter part of the century witnessed an increase in inward FDI but measured as the stock as percentage of GDP it was not as high in 1995 as at the beginning of the 20<sup>th</sup> century. Only by 2004, FDI measures are more ‘globalised’ than just before World War I. Once again, FDI is expected to play a relatively large role in development

**Table 1 Trends in FDI, 1913–2004**

	1913/14	1930s	1950s	1970/1	1980	1995	2003/4
Developed country	Outward stock of FDI/GDP (per cent)						
Canada	6	25	6	7	9	20	37
France	23	10		5		25	38
Germany	11	5		3	4	10	31
Japan	11	47		2	2	5	8
Netherlands	82	28		35	25	47	94
UK	49	18	9	17	15	28	65
US	7	8	4	8	8	18	17
Developing countries	Inward stock of FDI/GDP (per cent)						
Average colonies	42	61	35	14		19	
Average independent	36	37	17	9		14	
Average	40	51	30	13		18	26.4
Latin America					4	12	38
Asia					4	12	24
Africa					8	15	32

Sources: Twomey (2000) and UNCTAD (2005); definitions may differ by year.

There has always been a concentration in FDI flows across countries throughout the past 100 years, but importantly, the list of top countries has changed. In 1913, two thirds of world FDI was flowing to developing countries; now this has changed, and most FDI is amongst developed countries, and only a quarter of FDI is going to developing countries. Table 2 shows that the top recipients of investment in 1913 included mainly developing economies, while in 2001 China/ Hong Kong (China) was an exception as the only developing economy.

**Table 2: Stock of inward investment, main recipients**

	<i>1913/14</i>	<i>1913/14</i>	<i>Cumulative</i>		<i>2001</i>	<i>2001</i>	<i>Cumulative</i>
	<i>USD</i>	<i>%</i>	<i>(%)</i>		<i>USD</i>	<i>%</i>	<i>(%)</i>
	<i>billion</i>				<i>billion</i>		
USA	7.1	15.8	16	USA	6277	26.9	27
Russia	3.8	8.4	24	United Kingdom	2204	9.4	36
Canada	3.7	8.2	32	Germany	1866	8.0	44
Argentina	3	6.7	39	France	1431	6.1	50
Austria- Hungary	2.5	5.6	45	Netherlands	1027	4.4	55
Spain	2.5	5.6	50	Italy	943	4.0	59
Brazil	2.2	4.9	55	Japan	871	3.7	63
Mexico	2	4.4	60	Belgium/Luxemb.	741	3.2	66
India and Ceylon	2	4.4	64	Hong Kong (China)	608	2.6	68
South Africa	1.7	3.8	68	Canada	597	2.6	71
Australia	1.7	3.8	72	China	534	2.3	73
China	1.6	3.6	75	Switzerland	521	2.2	76
				Brazil	443	1.9	
				India	130	0.6	

*Source: Twomey (2000)*

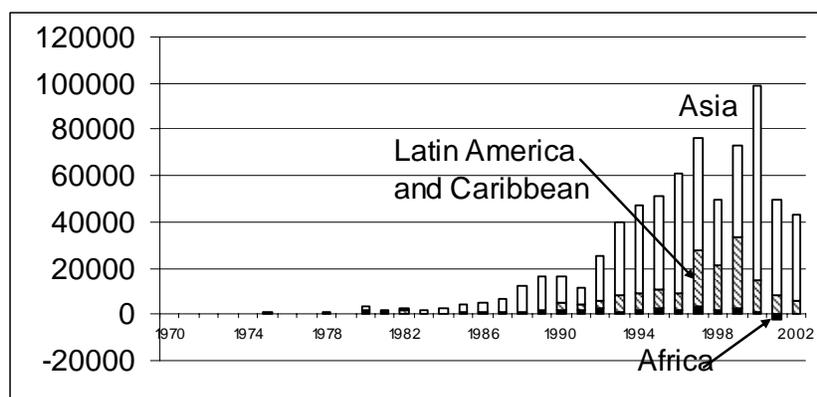
FDI is also concentrated amongst developing countries and regions. The top eight developing economies have been responsible for three quarters of inward FDI flows since the 1980s: China, Hong Kong (China), Mexico, Brazil, Singapore, Russian Federation, Chile and India. The top 25 developing countries receive 95% of inward FDI.

There are wide differences across regions. Chart 1 shows that the absolute values of FDI are highest for Asian developing countries, followed by Latin American and Caribbean countries, while African countries received comparatively little FDI. Sub-Saharan Africa has received 6% of world FDI in 1980 but its share has since decreased to 0.5% in 2000 and 2.2% at present. This in part reflects that large countries attract a lot of FDI since these economies also have the largest markets. In fact, controlling for market size, the inward stock as a per cent of GDP is 34% in sub-Saharan Africa, 28% in developing countries, and 21% in developed countries (UNCTAD, 2005). Several Asian countries (though not the continent as a whole) have been able to attract an even large value of inward FDI compared to their market size, reflecting their relative success in attracting FDI for export markets (in contrast the high value of FDI recorded in Latin America previously).

Outward FDI from developing countries has risen sharply over the past two decades and a half from negligible amounts (Lall, 1983; Kumar, 1995; Page 1998; Aykut and Ratha, 2003, and UNCTAD, 2004a). Most FDI has been by Asian firms establishing

footholds in other Asian countries but there has also been investment in developed countries such as the EU. China is now a major investor in Africa, and India is the sixth largest investor in the UK. Total investment by developing countries began to rise from about 1% of total foreign investment flows in the late 1970s to 4% in the mid-1980s and 6% by 1990, and after a peak in the 1990s before the Asian crisis, has remained around 6–7% of the total. South–South flows are estimated (as a residual, and noting challenges regarding data and methodology) to have risen from 5% in 1994 to 30% in 2000 of the total FDI inflows to developing countries, see Aykut and Ratha (2003).

**Chart 2 Developing country outward FDI (US\$ million), 1970–2003**



Source: UNCTAD

The composition of FDI flows has shifted markedly over time. In 1914, 70% of US FDI in developing countries was in agriculture, mining or petroleum; 26% was in services; and just 1% in manufacturing. In 1998 these figures were 14%, 59% and 27% respectively (Twomey 2000, Table 3.14, p. 55). There has thus been a marked change from natural resources FDI towards knowledge-intensive activities. Table 3 shows that the inward stock was already skewed towards manufacturing and services in 1990, but increasingly so towards services in the past 15 years in both developed and developing countries. Countries such as India have been able to attract increasing amounts of FDI in high value-added services, though other developing countries (Ghana, South Africa, Mauritius, Caribbean countries), have also attracted FDI in contact centres.

While FDI to developing countries in the beginning of the 20<sup>th</sup> century was mainly motivated by exploiting natural resources and building railways, FDI has increasingly been in efficiency-seeking FDI (e.g. textiles and clothing in East Asia from the 1960s, automobile industry in Asia and Latin America), and strategic asset-seeking FDI (e.g. technology activities in Singapore and Malaysia). Now, even the most strategic of functions (such as R&D) are expanding in some developing countries as transnational corporations (TNCs) seek to benefit from pools of talent at competitive costs (UNCTAD, 2005), particularly in those countries that have actively helped to create this (incl. Singapore, Malaysia, China and India).

**Table 3 Inward stock, by sector, 1990–2003**  
(US dollar millions)

	1990			2003		
	<i>Developed</i>	<i>Developing</i>	<i>World</i>	<i>Developed</i>	<i>Developing</i>	<i>World</i>
Primary	145404	24727	170131	428831	143993	594321
Manufacturing	595142	150410	745552	2081645	779112	2876102
Services	717147	157950	875097	4015555	1110757	5153826

Source: UNCTAD

Sectoral trends of FDI and sectoral composition differ by developing country and region. Several Asian countries have been able to attract more efficiency-seeking FDI in manufacturing (electronics, textiles) than other developing country regions. Latin America and the Caribbean countries have attracted large-scale natural resources FDI and services FDI through privatisations, and efficiency-seeking FDI in labour-intensive manufacturing (notably in Mexico, Dominican Republic and Central America). Africa has attracted mainly natural resources FDI, though some countries attract relatively more manufacturing (an example is South African automobile FDI, or Asian garment factories in Lesotho) or services (tourism).

The shift in FDI away from natural resources towards efficiency-seeking and strategic asset- and market-seeking FDI has also had implications for entry modes. For instance, privatisations in Latin America have accounted for a number of takeovers through cross-border Mergers and Acquisitions. There have also been an increasing amount of strategic alliances, in particular with Asian countries with appropriate technological capabilities.

A shift towards efficiency and strategic asset seeking FDI has also meant a growing globalisation of the production processes. A car used to be an assembly of metal pieces, and production by assemblers accounted for 65–70% of the total value-added. Organizational change, for instance, just-in-time (JIT) techniques, has facilitated the process of outsourcing. As a result, final assembly plants account for less than 40% of the value of a car, and the rest of the stages in the value chain takes place elsewhere: 30% of the value of the US car goes to the Republic of Korea for assembly, 17.5% to Japan for components and advanced technology, 7.5% to Germany for design, 4% to Taiwan and Singapore for minor parts, 2.5% for advertising and marketing services, and 1.5% to Ireland and Barbados for data processing (Venables, 2002). Fragmentation is also common in the semiconductor industry.

Fragmentation of production processes is also called ‘vertical specialisation’ and is commonly referred to as the relocation of parts of the production process from one country to another (Feenstra, 1998). Most of the attention used to focus on fragmentation of manufacturing, but more recently attention has also focused on fragmentation of services. Several estimates find that fragmentation of production into global production processes has been increasing in world trade. Campa and Goldberg (1997) find that the share of imported to total intermediate inputs (%) in manufacturing increased in Canada from 16% in 1974 to 20% in 1993, in the UK from 13% to 22%, and US from 4% to 8%. Many developing countries such as Malaysia, Thailand and Mexico have benefited from this, although poorer economies have benefited less from fragmentation in such sectors as electronics or automobiles. These shifts have implications for the impact of and policies towards FDI, having to deal with global production structures.

### 3 Changes in the determinants of FDI

The way that FDI affects growth and development depends for an important part on the type and volume of FDI. Thus, when understanding the impact of FDI, it is important to understand what attracts FDI, how this has changed over time, and what these changes in determinants and types of FDI mean for differential growth prospects.

The main determinants of inward FDI can be divided into several categories, and relate to

- General policy factors (e.g. political stability, privatisation)
- Specific FDI policies (incentives, performance requirements, investment promotion, international trade and investment treaties)
- Macro economic factors (human resources, infrastructure, market size and growth)
- Firm specific factors (e.g. technology). For instance, ICT developments have had a profound impact on the way companies structure their international activities. Most importantly, it has facilitated a more specialized production attracted to those locations that can offer the most competitive environment for any given activity.

There have been trends in all of these factors over the past decades and between them they can explain a large part of why FDI has gone more to some countries and regions than others. There have also been changes in their relative importance. The main point is that, as we will also see later, factors that have become increasingly important in attracting FDI (building up appropriate and good quality local capabilities) are also increasingly important in making FDI work for economic development.

#### *General policy factors*

The theory suggests that long term investment benefits from stability as it reduces the risks for the long-term investor. This is backed up by investor surveys, and to a large extent by the evidence. Politically unstable countries tend to receive relatively small amounts of FDI. The main exception to this rule are countries rich in natural resources which have managed to attract considerable amounts of FDI despite often unstable environments.

Trends in general policy factors have been important. Developing countries are increasingly creating a market friendly environment for the private sector to operate. Countries that have done this consistently over time have also attracted more FDI. Countries in some developing country regions such as Latin America have privatized earlier, and more broadly, than countries in other regions (e.g. most African countries), and have attracted significant flows of FDI (in utilities, banks, telecommunications, etc.).

Countries that provide a welcoming 'investment climate' will attract more investment, see, for example, the 2005 World Bank *World Development Report*. A welcoming investment climate depends on a combination of factors determining investment. This differs markedly across countries (UNCTAD's Investment Policy Review series, World Bank's Doing Business 2006) affecting the competitive advantage of

economies including their exports. For instance, there are differences with respect to e.g. business start-up costs, the flexibility of firing index, duration of enforcing contracts, costs of closing business. Djankov *et al.* (2000) show that heavier regulation of business entry is associated with higher corruption and thus weaker governance, deterring investment. Even though countries have begun to understand what a welcoming investment climate involves, with some reductions in red tape, there is still a wide variation in administrative and regulatory practices.

With increased liberalization of trade and investment regimes and technological advances in areas such as information and communication technologies, countries are increasingly concerned about the competitiveness of their economies. This involves paying more attention to created assets, such as skills and infrastructure. There is a divergence in the availability of these key sources of competitiveness across countries and hence in determinants of investment activities generally. It has been estimated, for example, that 40% of capital (DFID, 2000) is based outside Africa, while the Commonwealth Business Council finds that 40% of African skills is currently based outside the continent. The gap in skills and infrastructure between African and other countries is also increasing. Due to differences in skills and technological infrastructure, there is also gap in technology and innovation areas. See UNCTAD WIR 2005 and UNIDO's 2002/2003 industrial development report for the digital divide and technological and innovation capability indices. The same factors are also crucial for countries to derive benefits from FDI.

### *FDI policies*

Renewed confidence in the positive benefits of FDI has led many countries that were restricting FDI in the 1960s, 1970s and 1980s to be more open towards FDI in the 1990s (Safarian, 1999) and beyond. Governments are liberalizing FDI regimes as they associate FDI with positive effects for economic development in their countries (e.g. Lall, 2000a).

Much of the FDI potential in developing countries was not realized 3–4 decades ago because many countries had severe restrictions on foreign ownership, and many of what are now regarded conducive factors (e.g. a competitive environment, good quality local capabilities) were not in place. This is gradually changing. Almost all countries are now actively welcoming FDI. They have liberalised their investment regime, but at different points in time. South-East Asian economies (in 1960s: Hong Kong [China], Singapore, Malaysia) were first, while other Asian countries (Republic of Korea, China and India) and Latin America countries began to liberalise in the 1980s and 1990s (even the Republic of Korea, which had previously restricted FDI and imported technology through licensing, decided after the Asian crisis in 1997 to open up more to FDI for the capital and technology it could bring). Many African countries followed only in 1990s.

Investment liberalisation has coincided with an increased attention to FDI protection and promotion. Countries now actively try to attract FDI and have established FDI promotion agencies for this, thereby aiming to change an FDI screening task into true FDI promotion. The proliferation of other tools included incentives, export processing zones, science parks, etc. Restrictions on FDI on the other hand declined as

competition for FDI increased: there has been a decrease in the incidence of performance requirements, see below and UNCTAD (2003b).

### *Macro-economic factors*

General and specific FDI policies have become less restrictive to inward FDI. With fewer policy barriers, other factors have become more important as determinants. Amongst these are basic economic pull factors such as good quality and appropriate human resources and infrastructure, on the supply side, and market size and market potential on the demand side. Macro-economic policies that shape the underlying fundamentals of cost-competitiveness have become more important over time in attracting mobile FDI, and hence there is overlap with what the factors that are enhancing spillovers to local firms. Lall (2000b) argues that FDI location decisions will increasingly depend on economic factors and not on temporary policy interventions. There is some empirical support for this in Noorbaksch *et al.* (2001) who find that education is increasingly correlated with inward FDI. Lall (2001) argues that especially technical and engineering skills are useful for attracting technology intensive investment, pointing to the success of several East Asian countries.

Several econometric studies point to the importance of infrastructure for attracting FDI. Wheeler and Mody (1992) studying US manufacturing FDI found that 'infrastructure quality clearly dominates for developing countries', while specialized support services were a better determinant in developed countries that already have an adequate infrastructure. Kumar (2002) explains the sales of US and Japanese subsidiaries in 66 developing countries by a host of factors (income, distance, taxes, etc.) and finds that good infrastructure (transport, telecommunications, information and energy) is a positive and significant determinant of FDI.

An increasing number of surveys show that the lack of availability of skills and physical infrastructure is amongst the major impediments to investing in African countries (UNCTAD, 2000a; and Business Map, 2000). There is a complex relationship between FDI on the one hand and human capital and infrastructure on the other. While FDI requires good quality and appropriate infrastructure and skills, FDI itself also helps to enhance skills and infrastructure. While some countries have become stuck in a 'low skill-low income' trap (e.g. some Central American countries depending on apparel *maquiladoras*) others have been able to come out of this using effective and consistent education policies (Costa Rica moving into electronics and IT).

Much of the economic literature has tended to focus on general determinants of aggregated FDI, but the importance of factors will have differed depending on sector, type and motivation of FDI. For instance, it is difficult for countries to attract knowledge-based FDI without the sufficient domestic technological and human resource capabilities. It would be difficult to attract efficiency seeking FDI if trade conditions were very poor.

### *Firm specific factors*

Since the 1950s, researchers have attempted to understand the evolution of FDI through micro-economic factors. The international business studies have had a long

tradition studying TNCs and use an eclectic paradigm for FDI, the Ownership-Location-Internalisation (OLI) framework (e.g. Dunning, 1993). Authors such as Caves (1974) and Dunning have emphasised that TNCs need to have some firm-specific asset that differentiates them from domestic firm to compensate for the extra costs in terms of local knowledge that a foreign firm must incur to operate in foreign markets. The firm-specific asset is called an ownership (O) advantage. As the firm-specific asset is often related to access to some superior technology or to specific knowledge of production processes, foreign affiliates require the right skill-mix to use the specific technology and to handle a complex production process in usually large-sized plants. TNCs should also have an internalisation (I) advantage to internalise business contacts, and not to outsource. Finally, the reason why a multinational invests in one country but not in another depends on the country's locational advantage (L).

Markusen (1995) suggests that technology or the firm-specific asset (ownership advantage) is the main reason for FDI. The assertion that technology rather than different factor endowments and prices underpin FDI can also explain why trade and FDI can be complements rather than substitutes.<sup>2</sup> For instance, firms invest abroad to exploit a brand name. There have also been studies that have tested successfully for the so called 'knowledge-capital model' of FDI (see Carr *et al.*, 2001), in that technology related factors explain US outward FDI.

There is further evidence to suggest that technological developments are increasingly affecting the level and nature of FDI. Barry and Hannan (2002) have argued that that the post-war increase in FDI is concentrated in *products* with high income elasticities of demand. As income grows, these sectors grow more rapidly, and the share in expenditure of products embodying 'knowledge capital' rises. As the average ratio of firm-level to plant-level scale economies rises, so does the level of FDI and the FDI-to-GDP ratio. In practice, this means companies such as Unilever, Coca Cola, Deloitte and Touche and Shell invest abroad because they have some superior technology, brand name or management technique that they alone can exploit using a multi-plant firm and thus FDI.

The international business school also defined four categories of motivations for FDI: natural resources-seeking, efficiency-seeking, strategic asset-seeking and market-seeking FDI. Dunning began the examination of TNCs in his 1958 study of FDI, US FDI in the UK, but several things have changed over the 4 decades since. For instance, a special issues of *Transnational Corporations* in 1999, Volume 8(2) suggests that the role of US FDI in the UK has become less important, that FDI policy

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<sup>2</sup> Trade economists usually study the relation between trade and FDI through the Heckscher-Ohlin general equilibrium model that incorporates a link between a country's factor endowments, its production structure and factor rewards. A capital-intensive country tends to export capital intensive products. More exports will decrease capital rewards and increase labour rewards, under special conditions leading to the equalisation of factor rewards across countries. If trade is restricted, capital flows may lead to the same equalisation. Indeed, Mundell (1957) proved that (under special conditions) the H-O model predicts that trade and capital flows are substitutes, both leading to equalisation of factor rewards. Markusen has shown that this substitution relationship is based on the assumption that factor endowments alone are the basis for trade. Countries are assumed to be otherwise identical. If the basis for trade is some other difference between countries, such as technology and firm-specific assets, a complementary relationship may exist between FDI and trade.

has less reason to be discriminatory, but also that US FDI had become more strategic-asset seeking (Dunning, 1993); a shift in the role of TNCs, from exploiting home-base technology in international markets to the international sourcing of technology, United States TNCs developing technology locally in the United Kingdom have moved away from their historical focus on the industries in which they were strongest at home, e.g. electrical equipment, towards industries in which indigenous United Kingdom companies have the greatest technological expertise, e.g. in chemicals and pharmaceuticals (Cantwell); Finally, the key to the new approach to TNCs is that policy on FDI and policy on endogenous growth have converged. TNCs are regarded as central to the creation as well as diffusion of knowledge, within and between firms, and in cooperation with governments (Safarian; and also UNCTAD, 2005).

As noted above, there has also been a trend where the dominant entry of foreign firms is through cross-border mergers and acquisitions rather than through greenfield operations. In the short-run M&As lead to a financial transfer, while the greenfield investment would also lead to increased fixed capital formation, though this distinction is less strong for the long-run. In the long-run, the main difference seems to be that M&A tend to lead to increased concentration, while greenfield investment does the opposite (UNCTAD, 2000a). Mega M&A deals influence world FDI flows as they constitute a large part of developed country FDI (precise data are difficult to get), the value of cross-border M&As is currently similar to total FDI (this is also true for countries such as the US, where more than 90% of FDI comes through M&As). However, M&As still contribute for only a fifth of FDI in developing countries on average, of course with variations for those countries and regions that have privatized and attracted FDI in the process.

In conclusion, there has been a trend in the determinants of FDI over the past decades. The main point is building up appropriate and good quality local capabilities have become increasingly important factors in attracting FDI (as opposed to temporary FDI policy barriers). As can be expected, these key economic fundamentals and policies to enhance these also feature in the factors affecting the FDI-development nexus

## **4 Effects of FDI on economic growth**

Much has been written about the relationship between FDI and development (UNCTAD, 1999). We review the main impact areas and suggest there have been major changes within these, with an emphasis on how FDI relates to economic growth (we do not deal separately with inequality and poverty).

There are several areas though which FDI affects development (UNCTAD, 1999):

1. employment and incomes
2. capital formation, market access,
3. structure of markets,
4. technology and skills,
5. fiscal revenues, and
6. political cultural and social issues.

These effects can be static and dynamic, and they can be positive and negative. Table 5 draws originally on UNCTAD (1999) and reviews the type of effects in each of the areas. Although the mechanisms underlying FDI and development have not changed, the intricacies of these mechanisms need to be better understood if they are to prove beneficial (Narula and Lall, 2004).

FDI affects economic growth through all of the above channels. FDI can raise economic growth by increasing the amounts of factors or production (by increasing capital or employment, directly, or indirectly in local suppliers and competitors), in the traditional growth accounting context, or increasing the efficiency by which these factors are used (by using superior technology, or locating in high productivity areas, or through productivity spillovers), as expressed in the literature in endogenous growth (e.g. Aghion and Howitt, 1998) where FDI represents the port through which new ideas are gained. In the long-run, FDI induced productivity change is important for long-lasting economic growth (e.g. through spillover to local capabilities), while FDI induced build up of factors may only raise growth temporarily (e.g. by establishing a garment assembly factory).

Those countries whose local capabilities have been enhanced because of FDI (e.g. in Singapore and Ireland, where local suppliers have become global exporters) have also been able to benefit most from FDI in the long-term. However, those countries that attracted FDI in the apparel sector because of trade policy distortions (due to the Multi Fibre Arrangement quotas which governed world trade in textiles and clothing until 2005) without building up local capabilities or linkages, may have derive fewer long-term benefits from FDI. For instance, there are now fears that investors in Lesotho will have withdrawn, at a time that much apparel capacity is relocated to China.

Over the past decades, there have been several major shifts in relation to the impacts discussed in Table 5. First, in parallel to shifts in the nature and composition of FDI, the type and direction of impacts have changed. Secondly, the literature on the macro effects of FDI has evolved and become more sophisticated and nuanced over time. And thirdly, governments have increasingly realized that they can influence the types and direction of impacts through the appropriate mix of policies, and they have increasingly made use of such policies. At the same time, some policies used in the past are now regulated in various international treaties (see below).

#### *Impact Shift 1: The type and “real” direction of impacts have changed*

FDI was traditionally seen as an additional source of capital, vital for the development of countries with insufficient economic capacity and infrastructure, and where domestic saving rates are low. Many Latin American countries viewed FDI as an important source of external finance, particularly after the debt crises of the 1980s when many Latin American countries were starved of private capital. Of course, this view is still prevalent in many countries, and rightly so.

However, many governments have begun to realise that inward and outward FDI can do more than just address balance of payments issues. For instance, FDI has contributed to changing whole production structures, or the real economy, in South East Asian countries. FDI and foreign ownership in particular was also a source of access to new skills and techniques. FDI can help to increase productivity and thus

growth, and thereby also reduce poverty. Thus FDI has financial and real effects, and both types of effects are now regarded as positive. This was not always the case.

A more competitive world is likely to lead to better impacts of FDI. Moran (2003) discusses dramatic differences in performance between foreign owned firms that are tagged into a global production network and foreign owned firms that are domestically oriented. Encarnation and Wells (1986) examined 83 investment projects in 30 developing countries over more than ten years and demonstrated the dramatic difference between tightly integrated export-oriented plants and non-integrated domestic-oriented plants. Using cost-benefit analysis to evaluating inputs and outputs to the establishments at world market prices, it was found that the former generated a substantial increase in host country income, while the latter (between a quarter to a half of the sample) a decrease. Many investments in the developing world were under conditions of weak competition (as occurred more often in 1970s), with few competitors in-country and often to circumvent high tariffs walls behind which protected and inefficient sectors could develop. Such firms may well have had a negative impact on host-country development. Now, there tend to be more competitive economies, with more open trade regimes, so we would also expect more positive impacts.

Another perception that has changed dramatically over the past few decades relates to the technology aspects of FDI. Discussions in the 1970s were about inappropriate capital-intensive technology imposed on labour-abundant developing countries. For instance, Brecher and Diaz-Alejandro (1977) showed that FDI that comes in to circumvent quantitative restrictions and tariffs can immiserize host country development under certain conditions, where capital flows into capital-intensive sectors in protected activities (particularly in so-called import-substitution, IS, countries). Srinivasan and Bhagwati (1999) also argue that FDI in import-substitution countries is limited by the size of the market. And because there were many IS countries in 1970s, there was quite a negative view of the impact of FDI. Balasubramanyam *et al.* (1996) in a study of 46 developing countries, cross section over 1970–1995, argue that countries with outward oriented FDI policies have greater benefits from FDI than countries with import-substitution.

Since the 1990s however, FDI has been desired especially because of the new production technology and management techniques that it embodies (see also Safarian comment before). Indeed, foreign TNCs tend to be larger, pay higher wages, are more capital and skill intensive and introduce more up-to-date technology (see e.g. Dunning, 1993 and Caves, 1996). Some characteristics of TNCs relate simply to the size of the firm, which itself is often related to higher pay, more training and usage of the latest technologies. However, controlling for factors such as size, foreign ownership is still related to better performance (Dunning, 1993; Tan and Batra, 1995).

*Impact Shift 2: The macro-economic studies on impact of FDI have become more sophisticated and nuanced*

Different types of econometric studies have been used to assess the effects of FDI on growth and productivity. Macro and meso studies usually find positive and significant correlations between FDI and GDP per capita or productivity, often because FDI tends to locate in higher value-added industries or segments. It is not clear whether

productivity increases at the macro level are driven by spillovers to and learning effects in local firms, or only because of a composition effect. It is thus important to understand *whether* and *how* positive spillovers to local firms occur because FDI associated with positive spillovers has long-lasting effects for development.

Thus macro economic studies were also interested in conditions under which FDI affects growth. Some recent studies have argued that the contribution of FDI to growth is strongly dependent on the conditions in recipient countries, e.g. trade policy stance (Balasubramanyam *et al.*, 1996) or human resource policies. In an influential paper, Borensztein *et al.*, 1998) suggest that the effectiveness of FDI depends on the stock of human capital in the host country. Only in countries where human capital is above a certain threshold does FDI positively contribute to growth. Xu (2000) estimates a growth equation for different samples of countries and finds a significant positive effect of FDI on growth in samples of countries with higher levels of human capital.

Countering this, Carkovic and Levine (2005) used more advanced econometric techniques and argue that FDI does not exert an independent and robust exogenous effect on growth after accounting for other factors such trade openness. They also found no independent effect of FDI in countries with more education. But countering this view, Blonigen and Wang (2005) argued that inappropriate pooling of data from developed and developing countries was responsible for empirical results indicating that FDI does not significantly affect economic growth. These opposing views show that the jury is still out on whether FDI (in the aggregate) can ever relate significantly to growth and how. The book in which both papers appeared recommends further research into this area (Moran *et al.*, 2005).

One clear, but often overlooked implication in such multi-country macro studies, however, is that the impact of FDI at the macro level is not necessarily homogeneously positive or negative, consistent with the view that the impact of FDI depend on type of FDI, firm characteristics, economic conditions and policies. For example, Mirza and Giroud (2004) argue that (a) FDI aids development, but mostly through growth-related effects, rather than spillovers (at least in ASEAN), but (b) policies can make a difference in capturing the wider potential benefits of FDI.

This heterogeneous picture is also borne out by micro-level studies. Micro-level studies (e.g. Haddad and Harrison, 1993; Aitken and Harrison, 1999; and Djankov and Hoekman, 2000) find that the productivity level of foreign firms is higher than in domestic firms, but also that productivity growth in domestic firms is lower than it would have been in the absence of foreign firms (in Morocco, Venezuela, and the Czech Republic), or in other cases where there are positive spillovers (e.g. Mexico). The negative effects are sometimes associated with market stealing arguments, while positive effects relate to learning effects in local firms with much lower productivity levels than their foreign counterparts in the same sector. The overall effect of FDI on the host economy is perhaps weakly positive, though there are studies where the impact is negative and cases where the impact is positive (Moran, 2003). It seems that other factors, economic conditions and policies play a role in determining the impact of FDI on the local economy, and that while FDI and growth tend to go hand in hand *on average*, there are cases (countries, sectors, firms) where the effects are positive and where the effects are negative. Mortimore (2004) criticises spillover studies

(micro, and macro by implication) for assuming that the effect of FDI is automatic and does not depend on factors such as TNC strategies or policies. A certain categorisation of the channels of impact on growth and productivity does emerge from these studies: technology transfer, human resource training, deepening of production linkages, and enterprise development. FDI policies are increasingly focused on maximising the effects through such channels.

*Impact shift 3: Increased awareness that policies affect the FDI-growth nexus*

The rise of FDI, and the continued presence of FDI in countries, has led countries to think increasingly about the impact of FDI, rather than assume that all a country had to do was attract FDI. In the previous section we already emphasised the importance of three policies to enhance the positive effects of FDI (based on multi-country studies)

- Creating a liberal trade regime
- Related, creating a competitive environment
- And, building up adequate human resources

But there are also concrete examples from case study evidence 1) the start of a linkages programme between local and foreign firms in Ireland when FDI was thought to be too much enclave type; 2) continued upgrading from light manufacturing, to capital intensive FDI and knowledge intensive FDI in Singapore, and 3) the role of human resource development co-ordination in the South African automobile industry.

A host economy can benefit more from the presence of the foreign firm if the local firm can link to, e.g. as a supplier, or if it can learn from the foreign firm. Both of these benefits are more likely to be enhanced, the more appropriate are the local capabilities. Building up local capabilities cannot be left to the market alone, as it is associated with market failures. Appropriate technology and human resource policies will differ by country and hence a country specific approach is required (e.g. Lall, 2001). Policies to provide linkages between foreign and local firms have become more prominent over time (e.g. UNCTAD, 2001), as well as policies that are more coherent across the areas of investment, innovation, education, and enterprise development (UNCTAD, 2005).

Narula and Lall (2004) argue that FDI *per se* does not provide growth opportunities unless a domestic industrial capabilities base exists which has the technological capacity to profit from the externalities from TNC activity. Thus an understanding of how technological knowledge is acquired is relevant to how FDI affects development. Experiences of changes in FDI policies may help to illustrate. Firstly, both Ireland and Singapore realized that while they were successful in attracting electronic and pharmaceutical TNCs (mainly from US) in 1960s and 1970s, these firms were not sourcing as much from local firms as was hoped. To upgrade local firms, both countries introduced significant and consistent measures related to human resources support and link them with foreign firms (linkages programmes, see e.g. te Velde, 2003). The specific example of Ireland is also relevant in explaining the evolution of FDI determinants. While FDI was attracted by tax incentives in the 1960s, these had to be abandoned by the 1990s, and by then consistent human resource development policies had created a more stable determinant of FDI along side low tax rates.

**Table 5 Inward Foreign Direct Investment and economic development**

Impact Area	<i>Static effects</i>		<i>Dynamic effects</i>		
	Indicators	Differences between foreign and local firms	Potential dynamic benefits of FDI	Potential dynamic costs of FDI	Indicators
<b>Employment and Income</b>	Employment generation inside foreign firms Wage levels for staff with given characteristics	Foreign firms are larger and pay higher wages (especially for skilled employees) than local firms.	Provides employment and incomes directly.	May indirectly crowd-out other employment by replacing existing employment or pushing up factor prices; may lead to increased wage inequality.	Long-run employment generation inside firm and in suppliers and buyers Long-run wage development in foreign firms and spillover effects on wage levels in other firms inside or outside sector
<b>Physical capital</b>	Fixed capital formation Financial transfers	Foreign firms tend to be more capital intensive	Stable source of external finance, improving the balance of payments, and potentially raising fixed capital formation.	May pre-empt investment and opportunities of domestic firms.	Long-run relationship between FDI and domestic capital formation
<b>Market access</b>	Share of inputs imported Share of output exported	Foreign firms tend to be more trade intensive	Firms can gain access to export markets by using global networks of TNCs.	TNCs can maintain tight controls of export channels.	Long-run relationship between exports and FDI, and between imports and FDI
<b>Structure of factor and product markets</b>	Concentration in product and factor markets Profit margins	Foreign firms can often be found in sectors with 'barriers to entry'.	Entry by foreign firm may lead to more competition. This may reduce product prices.	The entry of foreign firms can lead to further concentration and market power. This may raise prices of own and other products.	Long-run relationship between FDI and profitability
<b>Technology, skills and management techniques</b>	Skill level of employees Training budgets Output per employee R&D budgets Types of technologies used	Foreign firms are more skill intensive, tend to use more up-to-date technologies and train more.	Provides up to date techniques, skilled personnel and advanced management techniques, raising the return to skills offering additional incentives for education. Positive spillover effects on domestic firms through backward and forward linkages, demonstration effects and human resource development.	Spillovers are not automatic or free. Reliance on foreign technology and skills may inhibit development of local capabilities. Increased linkages raise dependency of domestic firms on TNCs.	Intra and extra-sectoral spillover effects on productivity in other firms. Share of inputs sourced locally Supplier development Upgrading and long-run development of technology, training and skill levels in foreign firms
<b>Fiscal revenues</b>	Fiscal payments Grants to foreign firms	Tax holidays or outright grants are sometimes offered to foreign firms	TNCs can raise fiscal revenues for the domestic government through the payment of taxes in case of new economic activities with more value added.	If TNCs crowd-out domestic firms, fiscal revenues may actually be lower through the use of special tax concessions, eventually leading to an erosion of the tax base. Special tax concessions are an implicit subsidy and in case of lack of transparency can lead to rent-seeking behaviour.	Long-run fiscal payments through foreign firms and through a change in economic activity more generally.
<b>Political, social and cultural issues</b>			Foreign firms can expose host country to other norms and values, e.g. environmental management, ethics.	Foreign firms may lead to political, social and cultural problems, by imposing unacceptable values (labour and environmental standards) interfering with political regime, and are said to exacerbate existing problems of corruption.	
<b>Poverty</b>	Combination of how above indicators affect the poor Social investment Core health, environmental and infrastructure programmes		If the effects in this column are important, this provides an enabling environment thereby directly and indirectly alleviating poverty.	If the effects in this column are important, this provides a disabling environment thereby directly and indirectly worsening poverty.	Combination of the above indicators Long-run effect of social investment Long-run effect of core health, environmental and infrastructure programmes

Source: Duplicated from Te Velde (2004) building on table in UNCTAD (1999)

Policies in Latin America countries have also undergone changes. For instance, many countries came out of the import substitution regime in the 1980s and 1990s by introducing horizontal, and neutral policies. More recently, Chile and Costa Rica in particular, have begun to target FDI (Mortimore, 2004) and use appropriate education policies to link FDI with the local economy.

The specific example of the South African automotive industry, the main bright spot on the African manufacturing map, provides a useful view on the importance of knowledge and skills to investment decisions (Te Velde and McGrath, 2005). The industry has sought to move from a strategy located within the context of import substitution, where quality and costs were not comparable with international benchmarks, to a strategy designed to take advantage of globalisation and where some South African produced vehicles can be viewed as 'world class'. Although skills were in abundance, by the late 1970s it was evident that they were in need of upgrading, and the industry played a useful role to ensure that skills development was broadly sufficient for the industry's needs. The government put in place sectoral institutions to match supply and demand for training. The South African policy strategies for skills and for industrial development are still relatively recent but do appear to point to the scope that a developing country with comparative economic strength and state capacity has for positive interventions to support international competitiveness.

FDI was less successful in other cases, perhaps because policies affecting it did not change sufficiently or were not present. For instance, FDI in natural resources has been a mixed blessing in many developing countries. For instance, some countries have failed to capitalize effectively on its oil FDI, because they have not used revenues to upgrade different production processes, e.g. for appropriate skills and infrastructure. Other countries, on the other hand, did introduce measures to upgrade the workforce and infrastructure.

Infrastructure is another area where the attraction of FDI has been difficult, despite policy changes, but at least there has been a realisation that the policies up to then had not worked. Aid (and public investment) flows to the infrastructure sector has fallen dramatically until it constituted only 5% of OECD aid for Africa by the late 1990s. The UK based Commission for Africa called this a policy mistake. Significantly, the private sector has not filled the gap (except in telecommunications) and water firms for example vowed not to invest because of poor risk-return ratios. The response of donors has been increased commitments in aid for infrastructure, sometimes in combination with private investment.

One clear conclusion is that the effects of FDI on economic growth and development more widely is not necessarily homogenously positive or negative, consistent with the view that the impact of FDI depend on type of FDI, firm characteristics, economic conditions and policies. The type and sequencing of general and specific policies in the area covering investment, trade, innovation and human resources are important. Appropriate policies to benefit from FDI include building up local human resource and technological capabilities to capture productivity spillovers.

## 5 Policy developments

This section sketches broad trends in FDI related policies at the national and international level. While countries have resisted FDI in the past, most countries now seek to attract FDI, but with an awareness of the need to have appropriate policies in place to maximize the benefits.

While multilateral negotiations on investment have been rejected by both developed and developing countries on several occasions, there is an evolving framework of bilateral (number exploding in 1990s, increasingly including amongst developing), regional (more regions now include investment provisions) and multilateral (including GATS, TRIMs, ASM etc) agreements affecting national policymaking in the FDI area.

### *National, host country policies*

National FDI policies have increasingly become more liberal and provide increasingly for a welcoming investment climate. We discussed broad trends previously; table 6 shows that an increasing number of countries have introduced changes into their investment regimes that have become, broadly speaking, increasingly favourable towards private sector investment.

**Table 6 National regulatory changes, 1991–2004**

Item	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76	60	63	69	71	70	82	102
Number of regulatory changes of which:	82	79	102	110	112	114	151	145	140	150	208	248	244	271
More favourable to FDI <sup>a</sup>	80	79	101	108	106	98	135	136	131	147	194	236	220	235
Less favourable to FDI <sup>b</sup>	2	-	1	2	6	16	16	9	9	3	14	12	24	36

*Source:* database on national laws and regulations UNCTAD (2005)

*Notes:* <sup>a</sup> Includes liberalising changes or changes aimed at strengthening market functioning, as well as increased incentives.

<sup>b</sup> Includes changes aimed at increasing control, as well as reducing incentives.

A sub-set of national FDI policies concerns specific interventions, which have been used effectively only by those few countries with sufficient capabilities to implement and target them consistently and precisely:

- Fiscal and financial incentives
- Performance requirements
- FDI promotion (establishment of IPAs)
- Building industrial parks and export processing zones
- Promoting clustering of industries using R&D and technology centres
- Supporting training programmes

UNCTAD (1995, 2000b) surveyed the use of these *tax incentives* in a large sample of countries. Many countries use tax holidays, import duty exemptions and other incentives— and their use increased from 1995 to 2000. Many countries are actively competing for FDI with the use of tax incentives and grants. It is now quite common

for developing countries to offer tax holidays for foreign investors, at times more favourable than the treatment of investment by local firms. Incentives have worked under certain circumstances, i.e. attracting investment to Ireland in the 1960s, or to certain states in Brazil. However, there were little conscious attempts to do an a priori cost-benefit analysis. Incentives in Brazil for instance have been criticised for not making up for their costs (see Rodriguez-Pose and Arbix, 2001). Oman (2000) reported an increasing level of grant incentives. However, it seems that countries have begun to be less generous to foreign firms, sometimes under pressure from developed countries (e.g. through the OECD tax haven reports). In some cases, developed countries, such as the UK, have also become less generous with subsidies, as some of the firms it supported left soon after they had arrived. Instead, there is an increased awareness of the need to build domestic capabilities under non-discriminatory tax systems, where systemic competitiveness is more important than temporary tax interventions. This feeling comes on top of a rules limiting the use and extent of incentives favouring lagging regions in the EU.

Developing countries have decreased their use of *performance requirements* (ERT, 2000), in part because of increased competition for FDI, and in part because of developments in international investment agreements making the use of certain performance requirements actionable. In addition, there have been doubts about the effectiveness of PRs, see UNCTAD (2003a).

The growing attention paid by countries to foreign direct investment (FDI) is also reflected in the establishment of *investment promotion agencies* (IPAs). The number of IPAs worldwide has increased substantially since the 1980s and particularly in the 1990s. By 2002 there were 164 national IPAs and well over 250 sub-national ones (UNCTAD, 2004c). In 1999, annual IPA budgets worldwide amounted to \$1.1 million on average. Eight per cent of the agencies, mostly in LDCs, had an annual budget of less than \$100,000, while 21% operated with a budget of over \$5 million. Some IPAs are effective in targeting FDI and have been able to develop over time to include image building, and cluster, linkage support and other after care activities (Ireland, Singapore, Costa Rica) while IPAs in other countries have been unable to affect investment policy or ease barrier to inward investment.

The promotion of *clusters and industrial parks* is another type of specific (investment) policy that has become more popular over the past two decades. The Singapore EDB has followed a cluster approach over the past decade, targeting firms around the electronics/semi-conductor, petrochemicals and engineering industries. The cluster approach is an instrument of industrial policy which attracts FDI, but which also leads to enhanced linkages and spillovers. Industrial development policies based on clusters of activities, with each step in a value-adding chain feeding into other steps thereby generating positive externalities, was not practiced as aggressively previously, and owes much to the work by Porter (1985, 1998).

### *International policies*

There are also international FDI policies; all of them have become more liberal (or more protective of FDI) over the past 3 decades. We discuss bilateral, regional and multilateral investment policies.

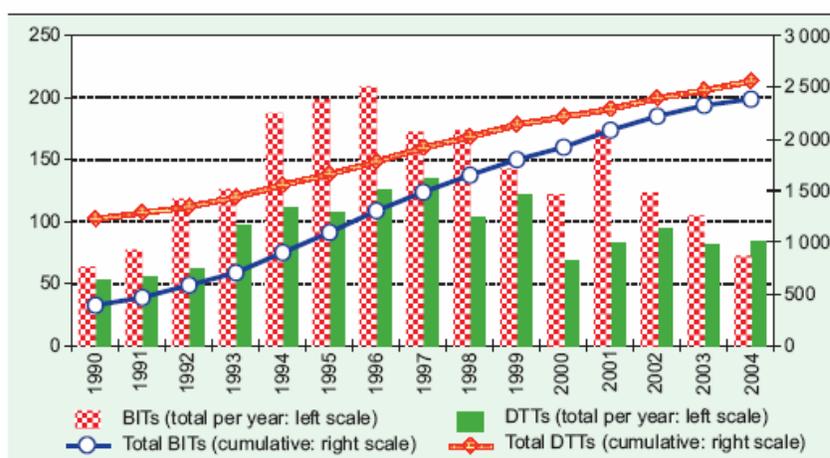
## Bilateral

There has been a surge in the number of bilateral investment treaties (BITs) from 500 in 1990 to close to 2,400 now. Some countries are more active than others. Germany and the UK are more active than the US, but most developed countries now have BITs in place with all their main investment partners in developing countries. However, some developing countries, such as Brazil and Botswana, have never depended on signing BITs. LDCs generally have few BITs in place. Increasingly, BITs are also being signed amongst developing countries. The contents differ, with US BITs more far-reaching (on market access) than most European BITs.

Empirical evidence on the impact of BITs on attracting FDI has been mixed. Empirical evidence on the impact of BITs on attracting investment, however, has been mixed. Some studies have found that the attraction of FDI is positively linked to signing BITs, but that BITs act as a complement rather than a substitute for strong political and legal institutions (Hallward-Driemeier 2003; Tobin and Rose-Ackerman 2005). Others have found a strong relationship between signature of BITs by the US and FDI flows (Salacuse and Sullivan 2005).

Double taxation treaties (DTTs) are other bilateral instruments affecting FDI. DTTs have risen similarly to BITs. Nearly 2,500 DTTs cover now more than 175 countries, with the strongest rise in the late 1980s (see chart 3). DTTs are important because it avoids the need for TNCs to pay taxes in both the home and host country. As developing country outward FDI is growing, so is the interest with developing countries in signing DTTs.

**Chart 3 Number of BITs and DTTs concluded, cumulative and annual, 1990-2004**



Source: UNCTAD

## Regional

While most regional integration agreements notified to the WTO include narrow provisions to liberalise trade, the new wave (Ethier, 1998) of regionalism that started in the 1990s has included investment provisions in about 20 cases. For instance, ANDEAN restricted FDI in the 1970s but this changed over the 1980s and 1990s. ASEAN has gradually added more investment provisions. NAFTA included quite strong provisions from its inception in 1994. SADC and COMESA contain weak

trade and investment provisions and have not yet really implemented any NAFTA type investment provisions. Generally, regions differ with respect to trade and investment provisions in two fundamental respects:

- *Over time*, when regions change or add investment-related provisions
- *Across regions*, when investment-related provisions differ between regions at one point in time

Table 7 measures trade and investment provisions for seven regions that are arguably the more advanced in the developing world regarding the inclusion of investment-related provisions. The Investment Index captures provisions on investment rules in RTAs and the extent of investment provisions. The following keys were used:

**Table 7 Regional Investment Provisions Index**

RTA (date of establishment)	<i>Value of Investment Index, by decade approximately</i>		
	1970s	1980s	1990s
NAFTA (1994)	0	0	3 (1994)
MERCOSUR (1991)	0	0	2 (1994)
CARICOM (1973)	0	1 (1982)	2 (1997)
ANDEAN (1969)	-1(1970)	1 (1987)	2 (1991)
ASEAN	0	1 (1987)	2 (1996), 3 (1998)
SADC (1992)	0	0	1 (1992)
COMESA (1994)	0	0	1 (1994)

*Source:* te Velde and Bezemer (forthcoming); years between parentheses indicate when certain provisions were announced.

- Investment Index
- = 0 if not member of group
  - = 1 if some investment provisions in region (as in COMESA, SADC),
  - = 2 if advanced investment provisions in region (e.g. improved investor protection in ASEAN)
  - = 3 if complete investment provisions in region (e.g. Chapter XI of NAFTA)
  - = -1 if more restrictive provisions (restrictions on foreign investors in ANDEAN in 70s)

The table shows that all of the regions considered have included more investment provisions over time. Te Velde and Bezemer (forthcoming) argue that an increase in regional trade and integration provisions has led to an increase in inward FDI to the region, but spread unevenly over countries within the region.

### Multilateral

The earliest multilateral discussions on investment date back to 1948. An attempt was made to formulate international principles concerning FDI in the Havana Charter of 1948, but it was rejected. Developments afterwards are described in UNCTAD (2004b).

The inclusion of a multilateral investment agreement was rejected at the OECD in the 1990s and more recently at the WTO, despite a proliferation of bilateral and regional investment agreements. However, some multilateral investment provisions do exist, e.g. the WTO Agreement on Trade Related Investment Measures (TRIMs), the Agreement on Subsidies and Countervailing Measures (ACM), and the General Agreement of Trade in Services (GATS), which covers conditions for FDI in services. There is little direct evidence on the impact of individual multilateral investment provisions. They should help to increase the stability of the investment climate, but it is challenging to separate the effects of multilateral measures from other effects (see Te Velde and Nair, 2005, on GATS and FDI in Tourism).

### *National, home country measures*

Home country measures (HCMs) are much less discussed than other factors affecting FDI, such as host country policies, international policies or multinational policies. Part of the reason is that policies on outward investment were traditionally seen as a screening device, restricting the outflow of capital. However, at the same time as host countries have begun to realize that attracting FDI can be good for development when appropriate policies are in place and have started liberalizing the FDI regime accordingly, so too have home countries seen potential benefits from outward FDI, and have started lifting restrictions on outward FDI. Countries employ HCMs because they promote the competitiveness and sales of domestic firms by supporting or promote development and reduce poverty. Some countries also see HCMs as a way to promote the development of the recipient countries.

HCMs include four categories of support:

- Support for structural economic fundamentals and governance structures in host countries, provided by development agencies.
- Support in reducing economic and political risks of an investment, provided by public risk insurers.
- Support in providing information surrounding investment, provided by trade and outward investment promotion agencies.
- Other policies that affect the viability of investment projects, such as fiscal policies and preferential trade policies in home countries.

Over the past 20 years there have been significant increases in such home country support. For instance, aid agencies have increasingly sought to find synergies between aid and investment, in ways that aid can support investment, and improve its impact, including through public-private partnerships.

**Table 8 UK (bilateral) aid as reported by OECD CRS. Distribution by sector**

	1973-1979	1980-1989	1990-1996	1997-2002
<b>Investment related aid</b>	<b>18</b>	<b>25</b>	<b>33</b>	<b>30</b>
<i>Infrastructure</i>	10	13	13	6
<i>Macroeconomic stability</i>	0	8	6	7
<i>Legal rules and policy</i>	0	0	2	3
<i>Private sector support</i>	2	3	4	3
<i>Human resource development</i>	6	1	9	11
<b>Other aid</b>	<b>82</b>	<b>75</b>	<b>67</b>	<b>70</b>

Source: OECD/DAC CRS data.

Table 8 shows that investment-related UK (bilateral) aid has increased since the 1970s, both in volume and in share of total (bilateral) aid, from 18% to currently 30%. Investment-related aid has shifted away from infrastructure towards macroeconomic stability, legal and policy frameworks and human resource development and institution building.

Voluntary codes of conduct have also sprung up, sometimes promoted by home countries. There is a wide variety of codes at sectoral, country and international level (see e.g. UN Compact Compact, <http://www.unglobalcompact.org/>). Companies themselves have also altered the way they think about FDI and development, and the concept for corporate social responsibility (CSR). Traditional CSR included charitable

giving by foreign companies. However, the last five years have seen an increased interest in so-called new CSR, which tries to map activities inside a company onto development related issues such as poverty (see e.g. UNCTAD, 2003a). Researchers (and in many cases companies themselves) are increasingly thinking about how their activities throughout the whole of the company including its core activities onto development priorities (Warner *et al*, 2002).

## 6 Conclusions

This paper has discussed trends in FDI and development from an historical perspective. The level and relative importance of FDI has fluctuated over time, and was high in the early part of the 20<sup>th</sup> century, low in the middle part and growing and high towards the end. Recently there has been an increase in FDI to developing countries, though concentrated in a few regions and countries. Inward FDI to developing countries has always been concentrated in a handful of countries, in part reflecting their economic wealth, but also reflecting the ability of countries to create the conditions that efficiency and strategic asset seeking FDI need, including appropriate and good quality human resource and technological capabilities.

The determinants of FDI have changed over time. While specific policy interventions (e.g. trade barriers) have affected FDI in many countries for long periods of time, FDI is increasingly looking for “sticky” places, with good economic fundamentals in place: market size and growth, good quality and appropriate skills and infrastructure. This has implications for how policies can now attract inward FDI.

Over the past 15 years, countries have regarded FDI increasingly as contributing to their development strategies for the technology and capital it provides, and therefore have started to compete for FDI. Investment policies have become liberal at the national and regional level, but there is still no comprehensive framework for FDI at the multilateral level. Home countries are also increasingly hoping to push FDI into developing countries using guarantee funds, matchmaking and other home country measures.

Home and host country have realised that they cannot only affect the *quantity* of FDI and hence possible growth prospects, but also the *way in which* FDI affects growth, productivity, employment, poverty etc. Countries have used general policies (improving the investment climate, incl. competitive and trade conditions) and specific policies (linkages programme, tailored human resource development) to make FDI work for development, in a way that is similar to trying to attract efficiency and strategic asset seeking FDI.

All in all, there has been a marked shift towards liberalisation of the FDI regime, and FDI is regarded more favourably now than a couple of decades ago. Governments have also realised that policies can influence the effects of FDI on development. No longer can it be assumed that FDI is mainly negative (as may have been a dominant perception in the 1970s) or only positive (as may have been a dominant perception in the 1990s). The type and sequencing of general and specific policies in areas covering investment, trade, innovation and human resources are all important. Appropriate policies to benefit from FDI include building up local human resource and technological capabilities to capture productivity spillovers.

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