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FDI and Development: Policy and Research Issues in the Emerging Context

Sanjaya Lall*

This paper is a general review of the emerging policy and research issues in the current context of rapid technological change and policy liberalization. It deals with the benefits and costs of FDI to development and the market failures that affect their impact on developing host countries. It focuses on the impact of FDI on local enterprise development, static versus dynamic benefits and bargaining with TNCs. It ends with a brief catalogue of outstanding research issues.

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* Queen Elizabeth House, University of Oxford

1. The new context for FDI

The large literature on foreign direct investment (FDI) and development reveals more than its fair share of controversy, large parts of it unedifying and unscientific. Until the 1980s, the general approach to transnational corporations (TNCs) and developing host countries reflected considerable suspicion and reservation. As Caves (1982) put it,

"MNEs have encountered hostility and resentment in all countries that host substantial foreign investment, but nowhere more than in LDCs, where they get blamed for the national economy's manifest shortcomings, not to mention that historical sins of colonial domination. Economic analysis has played no great part in resolving disputes between critics and defenders of the MNE's role in development processes. There is little consensus on what institutions and policies most effectively promote the goal of economic development, and writings on the economic development, and writings on the economic role of MNEs have correspondingly run a high ratio of polemic to documented evidence." (Page 252).

In recent years, however, the heat of the debate has subsidised considerably. By the closing years of the 1980's, there was a general warming of attitudes to FDI not just in the development literature but also on the part of the national governments traditionally strongly hostile to TNCs. There are many explanations for this change. There was a 'maturing' of the theory of international production, with a better appreciation of the nature and advantages of TNCs in host countries. The experience of developing countries, with some exceptionally successful countries drawing heavily on FDI and many regimes restrictive to TNCs faring poorly, led to serious rethinking of their role. Host developing countries improved their capabilities to deal with TNCs. The more advanced ones showed the ability to absorb leading-edge technologies transferred by TNCs, and to even attract R&D facilities. TNCs themselves changed their patterns of behaviour, and many new sources of FDI emerged, reducing the threat of domination by a handful of giant enterprises. The debt crisis – and the Asian financial crisis – showed that FDI was more stable in difficult periods than other forms of capital inflows.

Two other factors induced even greater changes in attitudes. The first was the accelerating pace of technological change and the rising costs of innovation. Reinforced by the growing reluctance of TNCs (the technological leaders) to part with valuable technologies to unrelated firms, this meant greater reliance on FDI to obtain new technologies. The second was the emergence of integrated production networks under the aegis of TNCs. Participating in these large, technology intensive and dynamic areas of activity necessarily meant that countries had

to invite TNCs. This has to be considered in the context of the pattern of world trade over the past two decades. Manufactured products grew much faster (four times faster) than primary products. Within manufactured products, growth was driven by technology. High-technology exports were the fastest growing group and resource-based products the slowest (Lall, 1998). In high technology exports, TNCs played the dominant role in most countries: thus their participation was almost a *sine qua non* of entering the most dynamic areas of export growth.

All these developments coincided with growing liberalization on trade and a more general reduction in the role of the state in economic activity. Liberalization was generally beneficial, removing many inefficient and uneconomic interventions. However, in some cases, the shift to market forces may have been carried too far. Possible deficiencies in free markets were ignored or glossed over. In the context of TNCs, some long-standing concerns were forgotten, some legitimately but others not. In its strong form, the neoliberal approach (the ‘Washington Consensus’) led many governments not only to remove all restraints to FDI flows but also to abrogate tools to attract, target, guide and bargain with TNCs. In the presence of market failures, the objectives of TNCs can differ from those of host governments: governments seek to spur development and TNCs to enhance their profitability and competitiveness. There is much overlap between the two, but there can also be differences.

A vital part of the emerging context is the need on the part of host countries to improve *national competitiveness*.¹ “Competitiveness” is taken here to mean the ability of economies to sustain income growth in an open setting. In a globalised world, growth can be sustained only if countries can create new, higher value-added activities that hold their own in free (domestic or export) markets. This requires many things, but central to them is the ability to use new technologies efficiently, furnishing the requisite skills and institutions.² Globalisation also affects the TNCs themselves. Their ownership advantages change in line with technical progress and shrinking economic space. Rapid innovation and deployment of new technologies to take advantage of changing costs, logistical needs and specific market demands become more important. The rising complexity of information flows means that TNCs have to organise

¹ Some economists (like Krugman, 1994) question whether national competitiveness is a legitimate policy concern for governments. They argue that firms compete with each other, not countries: all countries need do is provide a level playing field and let competitive firms and activities emerge in response to market signals. However, this is valid only to the extent that markets work perfectly. Market failures may lead agents to fail to exploit endowments or to develop new endowments. Where markets are weak and supporting institutions absent, information may not flow efficiently, risky projects may never be undertaken, costly learning may not be undergone, and externalities and linkages with other agents may result in underinvestment (Stiglitz, 1996). It then becomes necessary for governments to intervene to strengthen markets and institutions.

² For a recent review of the significance of technology to development see Radosevic (1999).

and manage their activities differently, changing relations with suppliers, buyers and competitors to manage better processes of technical change and innovation. They also have to strike closer links with institutions dealing with technology and skills. New TNCs are constantly entering the arena to challenge established ones. Many are small firms or previously publicly owned enterprises and utilities that were traditionally confined to home markets. A significant number are enterprises from developing countries.

A striking feature of the new context is how TNCs are increasingly shifting their portfolios of mobile assets across the globe to find the best match with the immobile assets of different locations. In the process, they are also shifting some functions that create their ownership assets like R&D, training and strategic management (the process of “deep integration”) within an internationally integrated production and marketing system. The ability to provide the necessary immobile assets thus becomes a critical part of FDI – and competitiveness – strategy for developing countries. While a large domestic market remains a powerful magnet for investors, TNCs serving global markets increasingly look for other attributes, which are changing in response to policy liberalisation and technical change. The opening of markets creates new opportunities and challenges for TNCs and gives them a broader choice of modes with which to access those markets. It also makes them more selective in their choices of potential investment sites.

Apart from primary resources, the most attractive immobile assets for export-oriented TNCs are now world-class infrastructure, skilled and productive labour, and an agglomeration of efficient suppliers, competitors, support institutions and services.³ Cheap unskilled labour still remains a source of competitive advantage, but its importance is diminishing. Moreover, it is not a base for sustainable growth, since rising incomes erode the edge it provides. Natural resources are similar, providing a rent as long as the particular commodities are in demand; however, without upgrading technologies or setting up downstream industries, they face the

³ As Narula and Dunning (1999) put it, “Globalisation has influenced both the nature of the comparative or location specific advantages of countries and the competitive or ownership specific advantages of corporations, and also the opportunity sets facing the governments of the former and the managers of the latter. *Inter alia*, value-adding activities have become increasingly knowledge- or information-intensive, not just in high technology sectors, but also in those that were previously regarded as natural resource- or labour-intensive. Both sets of institutions have thus adjusted their strategies and policies to the realities of the new global environment. First, the nature and content of MNE activity has undergone a marked shift, as their ownership specific intangible assets – especially intellectual capital – have become more mobile. Second, national governments are now increasingly competing with each other to attract mobile investment” (Narula and Dunning, 1999, pp. 1-2). On the importance of agglomeration economies for development, see Puga and Venables (1999).

risk of stagnant prices or substitution. In both cases, attracting TNCs' mobile assets requires host countries to improve the quality of their immobile assets.

There is no conflict between exploiting static sources of comparative advantage and developing new sources: existing advantages provide the resources with which to develop new advantages. The steady evolution from one to the other provides the basis for sustained growth. What is needed is a policy framework to facilitate and accelerate the process: this is the essence of competitiveness 'strategy'. The need for such strategy does not disappear with growth; it merely changes its form and focus. This is why competitiveness remains a concern of governments in advanced industrial nations as much as (if not more than) in developing ones; the former produce more competitiveness strategies, at more regular intervals, than the latter.

TNCs in developing countries

2.1 Introduction

Most developing countries consider FDI a vital resource for development. However, the economic effects of FDI are very difficult, if not impossible, to measure accurately. TNCs represent a complex package of attributes that vary over time and from one host country to another. They are difficult to separate and quantify. Where their entry has large (non-marginal) effects, measurement is even more difficult. There is no precise method of specifying a 'counter-factual' – what would happen if a TNC had not made a particular investment. As a consequence, the analysis of the effects of FDI resorts to one of two general approaches. The first is econometric analysis of the relationships between inward FDI and various measures of economic performance. The second is a qualitative analysis of particular aspects of TNC contribution, without any attempt at calculating a net rate of return.

The econometric analysis of FDI and development is of long standing, but its conclusions remain unclear. Some analyses show a positive impact while others remain agnostic.⁴ Since growth depends on many factors whose effects are difficult to disentangle, and since FDI itself affects several of these factors, an agnostic conclusion is probably the most sensible. As one leading analyst notes, most statistical analysis "has suffered both from the lack of theoretical guidance and in some cases from a surfeit of special pleading by the researchers" (Caves, 1982, p. 275).

The qualitative analysis of FDI, taking its different components separately, is more appealing and practical. The premise is FDI offers host countries a mixture of positive and negative effects. The challenge is to disentangle these effects, taking measures to maximise one and minimise the other. If TNCs operated in 'efficient' markets and acted with full information, there would be no need for policy intervention. If markets were not efficient, or TNCs did not have full information on investment opportunities in particular locations, there would be a case for interventions in markets and the investment decisions of TNCs. It is likely that markets and information are deficient in developing countries – under-development is typified by a lack of efficient markets and institutions.

There is another analytical issue. The existence of TNCs is itself a manifestation of market failure. Large oligopolistic firms can operate over national boundaries precisely because they are 'imperfect', with firm-specific ownership advantages over other firms, scale and scope economies and internalised markets for information and skills. All these violate the requirements of perfect competition. It is not clear, therefore, that the interaction between the efficient internalised markets of TNCs with the deficient ones of host developing countries will lead *automatically* to mutual benefit.

Policies on FDI are needed to counter two sets of market failures. The first arises from information or coordination failures in the investment process, which can lead a country to attract insufficient FDI or the wrong quality of FDI. The second arises from divergences between the private interests of investors and the economic interests of the host country. This can lead FDI to have negative effects on development, or to positive but static benefits. Private and social interests may of course diverge for any investment, local or foreign. However, some divergences are specific to *foreign* investment. FDI differs from local investment in that the locus of decision-making and sources of competitiveness in the former lie abroad. The foreign investor has less commitment to the host economy and is also more mobile. Many governments feel that foreign ownership has to be controlled on non-economic grounds, for instance, to keep cultural or strategic activities in national hands. Let us consider how TNC and host country interests may diverge under various headings.

⁴ For a recent published analysis see Borensztein *et al.* (1998).

2.2 What FDI offers

FDI comprises a bundle of assets, some proprietary to the investor and others not. The proprietary assets are what are termed the ‘ownership advantages’ of TNCs. These give TNCs an edge over other firms (local and foreign) and allow them to overcome the transaction costs of operating across national boundaries. The non-proprietary assets – finance, capital goods, intermediate inputs and the like – can be obtained from the market by any firm, though large TNCs may have privileged access to some markets. Proprietary assets reside in the firms that create them. They can be copied or reproduced by others, but the cost can be very high (particularly in developing countries and where advanced technologies are involved). TNCs are reluctant to sell their most valuable proprietary assets to unrelated firms that can become competitors or ‘leak’ them to others. These advantages mean that TNCs can provide assets to host developing countries that other firms cannot – if the host country can induce them to transfer their advantages in appropriate forms. The assets FDI comprises are:

- *Capital*: FDI brings in investible financial resources to capital scarce countries. The inflows are more stable, and are easier to service, than commercial debt or portfolio investment. In distinction to other sources of capital, TNCs invest in long-term projects, taking risks and repatriating profits only when the projects yield returns.
- *Technology*: Developing countries tend to lag in the use of technology. Many of the technologies deployed even in mature industries may be outdated. More importantly, the efficiency with which they use given technologies is often relatively low. Even if part of their productivity gap is compensated for by lower wages, technical inefficiency and obsolescence affect the quality of their products and handicap their ability to cope with new market demands. TNCs can bring modern technologies (many not available without FDI) and raise the efficiency with which technologies are used. They adapt technologies to local conditions, drawing on their experience in other developing countries. They may, in some cases, set up local R&D facilities. They can upgrade technologies as innovations emerge and consumption patterns change. They can stimulate technical efficiency in local firms, both suppliers and competitors, by providing assistance, acting as role models and intensifying competition.
- *Skills and management*: TNCs possess advanced skills and can transfer these to host countries by bringing in experts and by setting up training facilities (the need for training is

often not recognised by local firms). They also possess new, presumably among the best, management techniques, whose transfer to host countries offers enormous competitive benefits. Where affiliates are integrated into TNC networks, they can develop capabilities to service the regional or global system in specific tasks or products.

- Market access: TNCs can provide access to export markets, both for existing activities (that switch from domestic to international markets) and for new activities. More important is the fact that they are by definition the only way to enter the international production systems that increasingly dominate trade in sophisticated and high-tech products. Export activity in turn offers many important benefits: technical information, realisation of scale economies, competitive stimulus and market intelligence.
- Environment: TNCs often possess advanced environmental technologies and can use them in all countries in which they operate.

While TNCs offer the *potential* for accessing these benefits in one package, this does not mean that simply ‘opening up’ to FDI is the best way of obtaining them. As noted, there may be market failures in the investment process and possible divergences between TNC and national interests. This raises the following issues for host government policy:

- Information and coordination failures in the international investment process.
- Infant industry considerations in the development of local enterprises, which can lead inward FDI to “crowd out” these enterprises.
- Static nature of advantages transferred by TNCs where domestic capabilities are low and do not improve over time, or where TNCs fail to invest sufficiently in raising the relevant capabilities.
- Weak bargaining and regulatory capabilities on the part of host governments, resulting in the unequal distribution of benefits or abuse of market power by TNCs.

The complexity of the FDI package also means that there may be *trade-offs* between different benefits and objectives. For instance, countries may have to choose between investments that offer short as opposed to long term benefits; the former may lead to static gains but not necessarily to dynamic ones. A large inflow of FDI can add to foreign exchange and investment resources in a host economy, but it may lead to a crowding out of local firms or

create exchange rate problems. The desire to generate employment may lead governments to favour labour-intensive, low technology investments, while that to promote technology development may favour more sophisticated investors. Similarly, the desire to upgrade technology may call for heavy reliance on technology transfer by TNCs, while the desire to promote local innovation and deepening may require more emphasis on arm's length transfers to indigenous firms. There can be many such trade-offs, and there is no universal answer to how they should be made. As noted, there is no 'ideal' policy on FDI that applies to all countries at all times.

2.3 The international investment process

The factors affecting the TNC choice of location relate increasingly to efficiency and competitiveness. Resource-based investments apart, the sites that will receive most FDI are those that allow TNCs to set up facilities able to withstand global competition. This means that the host country has to provide competitive immobile assets – skills, infrastructure, services, supply networks and institutions – to complement the mobile assets of TNCs (Narula and Dunning, 1999). While transport costs and taste differences mean that large markets will continue to attract more investment than small ones, few countries can afford to take a continued inflow of FDI – especially high quality, export-oriented FDI – for granted. This means that the ultimate draw for FDI is the economic base of the host country: just offering incentives for investors cannot compensate for the lack of such a base.

This being said, however, there remains a strong case for proactive policies to attract FDI. Countries may not be able to attract the volume and quality of FDI they desire, and that their economic base merits, for one or more of three reasons. These are high transaction costs; deficient information on the potential of the host economy; and insufficient coordination between the needs of TNCs, the assets of the host economy and the potential to improve those assets.

High transaction costs. While FDI regimes are converging on a common (reasonably welcoming) set of rules and incentives, there remain large differences in how these rules are implemented. The FDI approval process can take several times longer, and entail costs many times greater, in one country than another with similar policies. After approval, the cost of setting up facilities, operating them, importing and exporting goods, paying taxes, hiring and firing workers and generally dealing with the authorities, can differ enormously. Such costs can

affect significantly the competitive position of a host economy. An important part of competitiveness strategy thus consists of reducing unnecessary, distorting and wasteful business costs. One important measure that many countries are taking to ensure that international investors face minimal costs is to set up one-stop promotion agencies able to guide and assist them in getting necessary approvals. However, unless the agencies have the authority needed to negotiate the regulatory system, and unless the rules themselves are simplified, this may not help. On the contrary, there is a risk that a “one stop shop” becomes “one more stop”.

Market failures in information. Despite their size and international exposure, TNCs have imperfect information on potential sites, and the decision making process can be subjective and biased.

“Prospective investors, even the largest firms, do not always conduct systematic world-wide searches for opportunities. The search for opportunities is a bureaucratic process whose initiation and direction may be swayed by many factors, including imperfect information and skewed risk perceptions. Most companies consider only a small range of potential investment locations. Many other countries are not even on their map” (IFC/FIAS, p. 49).

Taking economic fundamentals as given, it may be worthwhile for a country to invest in altering the perception of potential investors by improving its ‘image’ (Wells and Wint, 1990). Such promotion efforts are highly skill-intensive and potentially expensive. They need to be carefully mounted, and they must be targeted to maximise their impact. Targeting can be general (aimed at countries with which there are trade or other connections, or that lack past connections but are ripe for establishing them), industry specific (investors in industries in which the host economy has an actual or potential competitive edge), or investor specific. Investment promotion is *not* the same as giving subsidies or fiscal incentives: incentives play a relatively minor role in a good promotion programme, and good long-term investors are not the ones most susceptible to short-term inducements. The experience Ireland, Singapore and more recently Costa Rica (Spar, 1998), suggests that promotion can be extremely effective in raising the inflow of investment and of raising its quality.

Coordination. Effective promotion should go beyond simply ‘marketing a country’ into *coordinating the supply of immobile assets with the specific needs of targeted investors*. This addresses potential failures in markets and institutions for skills, technical services or infrastructure in relation to the specific needs of new activities targeted via FDI. A developing

country may not be able to meet such needs, particularly in activities with advanced skill and technology requirements. The attraction of FDI in such industries can be greatly helped if the host government discovers the TNC's needs and meets them. As Costa Rica illustrates, the fact that it was prepared to invest in training to meet Intel's skill needs was a major point in attracting the investment (Spar, 1998). Singapore goes further, and involves TNC managers in designing its on-going training and infrastructure programmes, ensuring that it remains attractive for their future high technology investments. The information and skill needs of such coordination and targeting exceed those of promotion *per se*, requiring the agency involved to have detailed knowledge of the technologies involved (their skill, logistical, infrastructural, supply and institutional needs) as well as of the strategies of the relevant TNCs.

2.4 Domestic enterprise development and FDI

The development of domestic enterprise is a policy objective of most countries, and the risk of 'crowding out' by FDI remains an important concern. Crowding out can take two forms: in product markets by adversely affecting learning and growth by local firms in competing activities, and in factor markets, by reducing access for local firms (particularly to finance).

The first issue reflects "infant industry" considerations (Bruton, 1998), though it differs from the usual connotation of protecting new activities against import competition. Here it takes the form of fostering incipient learning in domestic *vis à vis* foreign firms. FDI can abort or distort the growth of domestic capabilities in competing industries when direct exposure to foreign competition prevents local enterprises former from undertaking lengthy and costly learning processes. TNC affiliates also undergo learning locally, to master and adapt technologies and train employees in new skills. However, they have much greater resources to undertake this learning, and considerably more experience of how to go about learning in different conditions. In these cases, "crowding out" can be said to occur if potentially competitive local firms cannot compete with affiliates *at a given time*.

The infant industry argument for trade protection differs from that for domestic enterprise protection. Without trade protection, consumers benefit from cheaper imports but some domestic production, employment and so on are lost. Without local enterprise protection, there is still domestic production but less indigenous entrepreneurial development particularly in sophisticated activities. The net cost is that local linkages may be less and technological deepening constricted. As with all infant industry arguments, crowding out is economically

undesirable if three conditions are met. First, infant local enterprises are able to mature to full competitiveness if sheltered against foreign competition. Second, the maturing process does not take so long that the discounted present social costs outweigh the social benefits. Third, even if there are net social costs, there must be external benefits that outweigh them.

Crowding out can impose a long-term cost on the host economy if it holds back the development of domestic capabilities and retards the growth of a local innovative base. This can make technological upgrading and deepening dependent on decisions taken by TNCs, and in some cases hold the host economy at lower technological levels than would otherwise happen. However, it is important to distinguish between crowding out potentially efficient enterprises from affiliates out-competing inefficient local firms that cannot achieve full competitiveness. One of the greatest benefits of FDI is the injection of new technologies and competition that leads to the exit of inefficient enterprises and the raising of efficiency in others. Without such a process, the economy can lack dynamism and flexibility, and lose competitiveness over time, unless competition between local firms is intense and they face international competition (say, in export markets). TNCs can also *crowd in* local firms if they strike strong linkages with domestic suppliers, subcontractors and institutions (below).

The second form of crowding out reflects an uneven playing field for domestic firms because of segmentation in local factor markets. TNCs may gain privileged access to such inputs as finance and skilled personnel because of their reputation and size. They can raise entry costs for local firms, or simply deprive them of the best factors. They may also have stronger bargaining positions with the government and so garner larger favours. The same argument may apply if TNCs have privileged access to *foreign* factor markets, for instance if they can raise capital in world markets at lower rates than local competitors.

Both forms of crowding out raise legitimate concerns. Most governments wish to promote local enterprises, particularly in complex and dynamic industrial activities. Many feel that deepening capabilities in local firms yields greater benefits than receiving the same technologies from TNCs. Knowledge is not 'exported' to be exploited abroad, linkages with local suppliers are stronger, there is more interaction with local institutions, and so on. The few developing countries that have developed advanced indigenous technological capabilities, like Korea and Taiwan, have restricted foreign entry. Without building such capabilities, countries may languish at the bottom of the technology ladder. The possession of a strong indigenous technology base is not just vital for building the competitiveness of local enterprises – it is also

important for attracting high technology FDI and for R&D investments by TNCs. As noted below, the level of local capabilities determines the benefits of spillovers from foreign presence.

At the same time, there are risks in restricting FDI to promote local enterprises. For one thing, it is very difficult in practice to draw the distinction between crowding out and legitimate competition. If policy makers cannot do this efficiently and flexibly, they may simply prop up uneconomic, rent-seeking local firms, at heavy cost to domestic consumers and economic growth. For another, the context is itself changing. The danger of technological lags if TNCs are kept out in sophisticated activities is much greater now than, say, three decades ago. So is the risk of being unable to enter export markets for activities with high product differentiation and internationally integrated production processes. Few domestic firms from developing countries have a significant international presence in complex manufacturing activities. Since most countries are liberalising their trade regimes in any case, FDI may provide the most effective way to develop industry since TNCs face lower learning costs than local enterprises. It is very likely that in a liberal trade regime it is mainly large international firms with that will be able to undertake advanced industrial activities.

The right balance between regulating foreign entry and permitting competition depends on the context. As noted, some countries have built impressive competitive capabilities and world class innovative systems by restricting the access of TNCs, but the number of successes is low. Many others have restricted foreign entry without being able to promote competitive domestic enterprises in complex manufacturing activities. Success clearly depends on several things apart from sheltering learning. The most important are the competitive climate in which learning takes place and the availability of complementary inputs. If firms face intense competition, both locally and in international markets (say, through export activity), they have an incentive to invest in constant learning and upgrading. If they have access to ample human (particularly technical and managerial) resources, a strong science and technology infrastructure, and efficient suppliers, consultants and institutions, they are able to learn. Without a competitive setting and responsive factor markets, however, learning is likely to be stunted. Since many high-technology sectors have significant economies of scale and scope, the size of the domestic market is also important. In sum, the infant enterprise argument remains valid, and provides a case for policy intervention to promote local capability

development. However, restrictions have to be very carefully and selectively applied, monitored and reversed where necessary.

As far as access to factor markets is concerned, TNCs can crowd in as well as crowd out domestic firms. Crowding in can take place when foreign entry increases business opportunities and local linkages, raises investible resources or makes factor markets more efficient. Such stimulating effects are most likely when FDI concentrates in sectors that are undeveloped in host countries. Where local firms are well developed, however, but face difficulties in raising capital or other resources because of TNC entry, there can be harmful crowding out.

Similar considerations apply to *mergers and acquisitions* (M&As) by TNCs. M&As are becoming a common form of foreign entry in Latin America and Africa, and more recently in Asian countries affected by the financial crisis (UNCTAD, 1999). Some M&As may be of dubious developmental value. If, for instance, they only lead to a change of ownership without adding to productive capacity or productivity, they just add to the foreign exchange drain on the host economy. Some take-overs lead to asset stripping and large M&A inflows can become large outflows when the investments are liquidated, giving rise to exchange rate volatility and discouraging productive investment. Many countries, including developed ones, are concerned about the adverse impact on employment, though this may be part of a rationalisation effort that can raise productivity. They also worry about the effects of M&As on competition and market structure. In the absence of effective competition policy, a liberal stance on M&As may lead to undue concentration or suppression of competition in the domestic market.

On the other hand, M&As may yield significant economic benefits (Harzing, 1999). Where the investor makes a long-term commitment to the acquired firm and invests in upgrading and restructuring its technology and management, the impact is very similar to a green-field investment. In Thailand, for instance, M&As in the automobile sector are leading to restructuring and increased competitiveness, with a surge in commercial vehicle exports. FDI can play an important role in modernising privatised utilities like telecommunications and public utilities, as in many instances in Latin America. Foreign acquisitions can prevent viable assets of local firms from being wiped out; this can be particularly important in transition and financially distressed developing countries (Maucher, 1998).

The benefits of M&As depend on the circumstances of the country and the conditions under which enterprises are acquired. Several countries feel the need control M&As, in developed countries in particular for reasons of competition policy. The correct policy is not a blanket prohibition of M&As; this would involve the loss of large potential benefits in terms of foreign exchange, productivity and export growth (in any case, prohibition may not be permissible). However, there may be value in monitoring M&As, instituting effective competition policies, and placing limits on their amount when the macroeconomic situation justifies this.

This raises a related question: the effects of FDI on *market structure* in host countries. There has been a long-standing concern that the entry of large TNCs raises concentration levels within an economy and so leads to the abuse of market power. The risk is certainly present. TNCs tend to congregate in highly concentrated industries. Whether this means the abuse of market power is not clear. The correlation between foreign presence and concentration owes more to the nature of TNC ownership advantages than to anti-competitive behaviour. In small economies, efficient deployment of modern scale-intensive technologies is bound to lead to highly concentrated market structures. If these economies have liberal trade regimes, the danger of anti-competitive behaviour in such structures is largely mitigated. However, it remains true that effective competition policy becomes more and more important in a world in which very large transnational firms can easily dominate an industry in a host country – we take up competition policy below.

2.5 Static versus dynamic benefits

Many important issues concerning the benefits of FDI to technology, skills and competitiveness revolve around their static or dynamic nature. TNCs are highly efficient vehicles for the transfer of technologies and skills suited to existing factor endowments in host economies (i.e. *static* benefits). They adapt the same technology to very different levels of scale and complexity in different locations, depending on market orientation and size, labour skills, technical capabilities and supplier networks. Where the trade regime is conducive (and infrastructure adequate), they use the endowments to expand exports from the host country. Such activity can create new capabilities in the host economy and have beneficial spillover effects. In low-technology assembly activities, the skills and linkage benefits may be low; in high technology activities, however, they may be considerable.

Unless they operate in highly protected regimes, pay unduly low wages (as in some EPZs in low-skill assembly) or benefit from expensive infrastructure while paying no taxes, there is a strong presumption that FDI contributes positively to using host country resources efficiently and productively. This constitutes one major step up the development ladder, and it can apply to each host country depending on where it is located on that ladder.

In this context, one of the main benefits of TNCs to export growth is not simply their ability to provide the technology and skills to complement local resources or labour, but to provide access to large foreign markets. TNCs are increasingly important players in world trade (UNCTAD, 1999). They have large internal (intra-firm) markets, access to which is available only to affiliates: these markets comprise some of the most dynamic and technology-intensive products in world trade. They also control or have access to large markets in unrelated parties. They have established brand names and distribution channels, with supply facilities spread over several national locations. They can influence the granting of trade privileges in their home markets. All these factors mean that they enjoy considerable advantages in creating an initial export base for new entrants on the basis of their static resource endowments.

The development impact of FDI depends, however, on more than this. It also depends on the *dynamics* of the transfer of technology and skills by TNCs: how much upgrading of local capabilities takes place over time, how far local linkages deepen, and how closely affiliates integrate themselves to the local 'learning system'. As noted, sustainable growth is more the outcome of dynamic sequences than the static ones, though there need be no necessary conflict between the two. However, TNCs may simply exploit the existing advantages of a host economy and move on as those advantages erode. Static advantages may not automatically transmute into dynamic advantages. This possibility looms particularly large where the host economy's main advantage is cheap unskilled labour and the main TNC export activity is low technology assembly. The extent to which TNCs dynamically upgrade their technology and skill transfer and raise local capabilities and linkages depends on the interaction of *four factors*. These are the trade and competition regime; government policies on TNC operations; the corporate strategy and resources of the TNC; and development and responsiveness of local factor markets and institutions.

The *trade and industrial policy regime* in the host economy provides the incentives for enterprises, local and foreign, to invest in developing local capabilities. In general, the more competitive and outward-oriented the regime, the more dynamic is the upgrading process. A

highly protected regime, or one with stringent constraints on local entry and exit, deters technological upgrading, isolating the economy from international trends. This is not to say that completely free trade is the best setting. Infant industry considerations deem that some protection of new activities can promote technological learning and deepening. However, even protected infants must be subjected to the rigours of international competition fairly quickly – otherwise they will never grow up. This applies to affiliates as well as to local firms, though, as noted, their learning processes are likely to differ. A strongly export-oriented setting with selective trade interventions provides the best setting for rapid technological upgrading.

The second is *policies on TNC operations*: local content requirements, incentives for local training or R&D, pressures to diffuse technologies and so on. Most host countries have used such policies. The results have been poor when they were not integrated into a wider strategy for upgrading capabilities. However, where countries used them as part of a coherent strategy, as in the mature NIEs, the results were highly beneficial: TNCs enhanced the technology content of their activities and of their linkages to local firms, which were supported in raising their efficiency and competitiveness. Much of the effort needed by the TNC to upgrade local capabilities involves extra cost and effort; they will not undertake this effort unless persuaded or induced to do so. For the host economy, it is only worth doing so if it leads to efficient outcomes. If upgrading is forced beyond this limit it will not survive in a competitive and open environment. The use of performance requirements is now being constricted by international rules such as TRIMS. While there are good reasons for pressing for greater market orientation and level playing fields, it is important to retain policies to correct for market failures – in this case in information, linkage and cluster formation, and learning.

The third factor is *TNC strategies*. Firms differ between themselves in the extent to which they assign responsibility to different affiliates and decide their position in the global value chain. TNCs are changing their strategies in response to technological change and policy liberalization, and much of this is outside the scope of influence of developing host countries. Nevertheless, host governments can influence aspects of TNC location decisions by such measures as targeting investors, inducing upgrading by specific tools and incentives and improving local factors and institutions (below). This requires them to have a clear understanding of TNC strategies and their evolution; they cannot formulate effective strategies otherwise.

The fourth factor, the state and responsiveness of *local factor markets and institutions*, is probably the most important. Since TNCs respond rationally to competitive pressures and market signals, they will upgrade their affiliates where it is cost efficient to do so. Moreover, since firms prefer their suppliers to be nearby, they will deepen local linkages if the suppliers can respond to new demands efficiently. Both depend upon the efficacy and development of local skills and technological capabilities, supplier networks and support institutions. Without improvements in factor markets, TNCs can improve the skills and capabilities of their employees, but only to a limited extent. They cannot displace the local education, training and technology system; in the absence of rising skills and capabilities generally, it will be too costly for them to import advanced technologies and complex, linkage-intensive operations

Education, training and technology markets have well-known public good characteristics which lead to market failures. Individuals may invest too little in education because of myopia, risk aversion, lack of information or the lack of finance. Institutions may not provide the right kinds of skills, or may be absent altogether. Other firms may under-invest in training and knowledge creation. SMEs may not receive adequate technical, training and marketing support. Raising local skills and capabilities requires widespread policy support. Some are pure public goods that only governments can provide. Others need governments to catalyse private provision (including by TNCs themselves) and to regulate its quality and delivery. Whatever the nature of such improvements, there is no doubt that they are critical to realising the dynamic benefits of foreign (and domestic) investment.

At the same time, there exists the risk that TNCs *inhibit technological development* in the host economy. TNCs are highly efficient at transferring the results of innovation performed in advanced industrial countries, but less so in transferring the innovation process itself. While there are notable exceptions, foreign affiliates tend to do relatively little R&D apart from that needed for local absorption and adaptation. For US TNCs, for instance, R&D by developing country affiliates in 1994 came to only 7.6% of total overseas, or 1% of parent company, R&D. Even this was very concentrated. Brazil accounted for over one-quarter of affiliate R&D in the developing world; the top four countries, with Mexico, Singapore and Taiwan Province, accounted for 77.4%. Least developed countries had no significant affiliate R&D.

The absence of affiliate R&D may be acceptable in host countries at very low levels of industrial development. However, it becomes a constraint on technology development and competitiveness as countries approach maturity and need to deepen local capabilities and

institutions. At the stage reached by many newly industrialising countries, the presence of powerful TNCs with ready-made technology can inhibit local technology development, especially when local competitors are too far behind to gain from their presence. Their technology spillovers may, in other words, be negative; there is evidence of this even in advanced host economies such as the UK or Italy (Perez, 1998). It is widely known, nevertheless, that countries with strong domestic research capabilities and institutions attract considerable R&D by TNCs. This is the ‘asset seeking’ form of FDI that plays an increasing role in globalisation by large firms.

More important, even countries without a strong research base can attract considerable TNC R&D if they are target FDI in technology-intensive activities and furnish the skills needed for sophisticated research work. For instance, in 1995 TNCs accounted for nearly 70 percent of R&D in Ireland; in that year, total firm-financed R&D in Ireland was higher than in the UK (OECD, 1999). Their role in Singapore is similar: it has the third highest ratio of enterprise-financed R&D to GDP in the developing world, with most of it coming from foreign affiliates (Wong, 1995). The strategy it used was to target technology intensive TNCs, give incentives for the transfer of advanced functions and invest heavily in advanced education and training.

The appropriate policy response, as before, is not to rule out FDI but to use it so to promote local learning. In countries that have technological ambitions for local firms and strong technological capabilities, selective restriction of FDI may be justifiable. In others, it may be possible to induce advanced TNC technological activity by FDI targeting, incentives and building skills and institutions. As before, there are no general prescriptions – FDI strategy is an art not a science.

2.6 Bargaining and regulation

In several cases, the outcome of FDI depends on how well the host government bargains with TNCs. However, the capacity of developing host countries to negotiate with TNCs is often limited. The skills and information available to the TNC tend to be of better quality. With growing competition for TNC resources, the need of many developing countries for the assets of TNCs is often more acute than the need of TNCs for the locational advantages offered by a specific country. In many cases, particularly in export-oriented investment projects where natural resources are not a prime consideration, TNCs have several alternative locations. Host countries may also have alternative foreign investors, but they are often unaware of them.

It is therefore a distinct possibility that where the outcome of an FDI project depends on astute bargaining, developing host countries do poorly compared to TNCs. The risk is particularly large for lumpy resource extraction projects and the privatisation of large public utilities and industrial companies. Considerable bargaining also takes place in manufacturing projects where incentives, grants and so on are negotiated on a case-by-case basis (there is intense and prolonged bargaining for large manufacturing investments in developed countries). Though the general trend is towards non-discretionary incentives, considerable scope for bargaining still exists.

The need for regulation is growing in importance. The capacity of host developing countries to regulate enterprises in terms of competition or environment policy is emerging as the most active area of policy making in this area. With globalisation and liberalization, there are few tools left to ensure competitive conduct by foreign and local firms: effective competition policy is an absolute necessity. However, most developing countries lack effective *competition policy*. Many, in fact, are not aware of the need for such policy. Mounting such policy is a complex task, with needs for specialised skills and expertise that are often scarce in developing countries. It is important for host countries to start the process of developing these.

Similar concerns arise with respect to the *environment*. Many developing host countries have lax regulations on the environment, or lack the capacity to enforce effectively the regulations they have on paper. TNCs are often accused of exploiting these to evade tougher controls in the developed world; some host countries are accused of using lax enforcement to attract FDI in pollution intensive activities. The evidence on the propensity of TNCs to locate their investments to evade environmental regulations is mixed (UNCTAD, 1999). Some firms may well do so; others enforce uniformly strict standards in all their affiliates and even require their local suppliers to observe those standards. TNCs are under growing pressure to conform to high environmental standards from home country environmental regulations, consumers, and environment groups in the developed world (and some in the developing world). Many thus see environment management not only as necessary but also as commercially desirable. However, it is up to host governments to ensure that other TNCs and domestic firms follow the example set by these ‘green’ TNCs.

Another important regulation problem is that of *transfer pricing* to evade taxes or restrictions on profit remission. TNCs can now use transfer pricing over very large volumes of trade and service transactions. The problem is not restricted to dealings between affiliates, and may also

arise in joint ventures. However, it is likely that the deliberate abuse of transfer pricing has declined as tax rates have fallen and remittances liberalised in much of the developing world. Double taxation treaties between host and home countries also lower the risk of transfer pricing abuses. However, this does not mean that the problem has disappeared. It remains a widespread concern among OECD countries and tackling it needs considerable expertise and information. Developing country tax authorities are generally ill equipped to do this, and can benefit greatly from technical assistance and information from OECD governments.

Managing effective FDI policy in the context of broader competitiveness strategy is a demanding task. A passive *laissez faire* approach is unlikely to be sufficient because of deficiencies in free markets and existing institutions. Such an approach may not attract sufficient FDI, extract all the benefits it offers or regulate it well by best practice standards. However, the desirability of any strategy depends critically on the ability of the government to ‘deliver’. If administrative capabilities are not appropriate to the skill, information, negotiation and implementation abilities needed, it may be best to minimise interventions with the market: to simply reduce obstacles in the way of FDI, minimise business costs and leave resource allocation to the market. As noted, there is no ideal universal strategy on FDI. Strategy has to suit the particular conditions of the country at the particular time, and evolve as its needs change and its competitive position in the world alters.

Finally, to return to the new context: what is different today in the FDI scene from three decades ago? Perhaps the most important change is technological: the world is more closely knit, using very different means of organisation, communication and production, and more subject to rapid change, than ever before because of constant and pervasive technical change. The leaders in the innovation process are TNCs. Countries are responding to the technological challenge, and to past development experience, by liberalising their economies. However, the spread of technological benefits is highly uneven, and the activities of TNCs do not reduce this unevenness – they may exacerbate it. Part of the reason for this is that many countries lack the capabilities and institutions to cope with a globalised world. The past thirty years show striking – and growing – differences between countries in their ability to compete and grow. They also show how markets by themselves are not enough to promote sustained and rapid growth: there is a large role for government policies, but not in the earlier mould of widespread intervention behind high protective barriers. This change in the perception of the role of government is another major change, and it applies to FDI as to development more generally.

Outstanding research issues

Recent development experience, a disillusionment with interventionist policies, growing government sophistication and adverse international economic circumstances, have combined to produce a much more favourable, and less controversial, environment for direct investment flows. The ‘maturing’ of the literature on TNCs in development reflects this shift. This maturity is to be welcomed, since many of the heated debates of the past were arid and irrelevant. It does not mean, however, that all important issues have been resolved as far as FDI and development is concerned.

At the margin, TNCs are rather similar in behaviour to large local firms but have much to offer in terms of their ownership advantages: with sensible trade and industrial policies, therefore, their effects are likely, on balance, to be beneficial. When non-marginal differences are considered, however, their effects are more ambiguous. Much depends on the economy’s initial and evolving conditions. A strategy of restricting TNC entry may provide a period of protection to capability building, if domestic market failures are efficiently tackled, skills promoted and local enterprise encouraged. TNCs can then be selected according to the dynamic rather than the static comparative advantages of domestic firms. This strategy may, on the other hand, be economically costly if local enterprises and capabilities are not developed and if corrective policies are not taken in hand. A choice between these alternatives is often one of degree, but recent experience suggests that in practice there can be very real differences in the strategies pursued.

What then are current research issues? Here are some ideas from a development economist who believes that the main need is for research to help developing countries cope with rapid and relentless globalisation and with the competitive pressures generated.

At the most *general level*, what is lacking is a *sound theoretical base*: a theory of development that can take market failures into account and suggest practical remedies for structural problems. Existing theories are often rooted in equilibrium systems where market failures are absent or trivial. They tend to end with simple solutions (liberalise and ‘get prices right’). The proper consideration of TNCs in development requires a more complex framework for analysing the development process, taking account of market and institutional imperfections and their correction. This is clearly an area of future research, considerably broader than FDI but directly relevant to it.

At the *narrower level* of FDI issues directly, some important questions are as follows:

- The *scope for effective policy* on FDI and for *bargaining* between TNCs and host countries. The trend of policy liberalization, reinforced by the WTO and new rules like TRIMS, is towards reducing the power of host governments to intervene in the market-determined investment process. How much scope will be left if something like the failed MAI by the OECD is concluded in the future? How will such agreements affect bargaining between governments and TNCs? Will they affect governments of countries of different sizes and incomes differently? What tools of FDI attraction, guidance and control on FDI will be left?
- The *impact of technological changes* on FDI and TNC strategies. Technical change is altering patterns of national and corporate comparative advantages constantly, shifting some activities back to advanced countries and others to developing ones. There are large shifts under way within the developing world, with increasing divergences between the NIEs and least developed countries. A number of important issues arise. To what extent is FDI accelerating these shifts? Can it be made to reduce divergences rather than exacerbate them? What are the effects on developing host countries of the trend to strategic alliances between the leading TNCs? Will technical change and increased competition lead to more technological effort being located in developing countries or less? At the corporate level, how do new information and communication technologies affect the location of strategic activities? Do they lead to greater centralisation or otherwise (what UNCTAD, 1999, terms 'deep integration')?
- The new drivers of *FDI location*. It is clear that in a liberalised world the factors attracting TNCs are different from before, but what are the main motive forces in investment location? How important are large domestic markets? The availability of skilled manpower? Physical infrastructure? Investment incentives? Belonging to large regional groups? Answers to this set of questions are vital to the formulation of FDI policies in developing countries. There are many reports based on rankings of factors by TNC executives, but these are analytically unsatisfactory. Econometric analyses of investment patterns are better but they also fail to provide the kinds of detailed and industry specific issues governments have to face.

- *FDI promotion.* The examples of Ireland and Singapore are often cited as best practice, and the broad nature of their strategies is known. However, the details are less well understood, and the steps that less advanced countries need to take to set up efficient promotion agencies are not clear. What are the emerging best practices in promotion and targeting? What sorts of skills are needed? What sort of information? How is investor targeting and monitoring operated? Which TNCs respond best to promotion? Which industries are most amenable?
- The impact of FDI on *domestic technological effort and entrepreneurship* remains a controversial and important area. The ‘stylised fact’ is that the countries that have built up the strongest domestic technological capabilities have restricted FDI. However countries like Singapore and Ireland are attracting considerable R&D effort from TNCs; there are indications that Malaysia and Mexico are following some distance behind. What are the trade-offs between attracting FDI and deepening technological activity? What are the limits of depending on TNC-led R&D especially if the domestic technological base is weak? There are also issues related to linkages between TNC affiliates and local suppliers and buyers. Are these growing stronger or weaker with trade liberalization and the removal of local content rules? What can be done to raise the intensity of vertical linkages?
- The nature and scope of emerging *integrated production systems*. At this time, these are expanding very rapidly but will they continue to do so? Which countries will they embrace and which not? What are their linkages with the economies of the host countries? What are their industry-specific characteristics? How much of world trade will be covered by these systems? What can host governments do to break into these systems?
- How can TNCs contribute to *human capital formation* in host countries? What is the best way of inducing training and skill transfer? Do strict rules on the use of expatriate experts constrain FDI and skill development? How can TNCs cooperate with host firms and institutions in training?
- What is the recent evolution of *developing country TNCs*, and what are the prospects for increasing FDI flows among developing countries? How are comparative advantages of first and third world TNCs evolving?

- How can the *international community* help developing countries attract, regulate and extract the maximum benefits from FDI? What, in other words, are the ‘global public goods’ in the form of rules, information, advice and technical assistance that may strengthen their position?

This is clearly not an exhaustive list, but it does reflect the author’s experience of policy-related work in recent years. There must be many interesting theoretical issues on which research can also be done, but in view of current priorities I would plead for the above.

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