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## Working Group on the Relationship between Trade and Investment

### SYNTHESIS OF THE INFORMATION MADE AVAILABLE TO THE WORKING GROUP ON THE LINKS BETWEEN FOREIGN DIRECT INVESTMENT AND DEVELOPMENT

Note by the Secretariat

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## I. INTRODUCTION

1. The present note has been prepared by the Secretariat in response to a request made by the Working Group for a synthesis paper based on the information received so far from Members and intergovernmental organizations on the links between foreign direct investment and development, both historically and in the present situation. It was understood that the paper would not be regarded as exhaustive, but rather as capable of further evolution as the work progresses.<sup>1</sup>

2. In accordance with the mandate under which the Note has been prepared, the focus is on foreign direct investment (hereinafter "FDI"), as distinguished from other forms of investment.<sup>2</sup> However, the Note takes into account that, in some instances, for example in regard to the macroeconomic implications of FDI, reference has been made to other forms of investment to provide a context that facilitates the understanding of the specific effects of FDI.

3. The Note deals successively with: first, certain general themes that have been raised regarding recent trends in FDI having a bearing on its impact on development (section II); the contribution of inward FDI to development, viewed as a vehicle for the transfer of a range of tangible and intangible assets to host economies (section III); the impact of outward FDI on development (section IV); and policies for maximizing the development return from FDI (section V).

4. It will be recalled that the Working Group initiated its work on these matters by first asking intergovernmental organizations to make contributions summarizing the results of relevant analytical work carried out in these organizations.<sup>3</sup> Accordingly, the structure of the individual sections of this Note is generally that of, first, a summary of the information contained in these contributions, followed by points made in written contributions by Members and in statements made at the meetings of the Working Group.

## II. RECENT TRENDS IN FOREIGN DIRECT INVESTMENT HAVING A BEARING ON ITS IMPACT ON DEVELOPMENT

5. Several key features of recent trends in the volume and pattern of global FDI flows have been highlighted in the contributions by the intergovernmental organizations:

- Global FDI inflows and outflows increased almost fourfold between 1983-1988 and 1996.<sup>4</sup> The growth rate of worldwide FDI flows during this period exceeded that of world trade by a considerable margin and constitutes in the view of some intergovernmental organizations a key motor of international economic integration.

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<sup>1</sup> M/3, paragraph 10. Documents issued in the WT/WGTI/M/- series are referred to in this Note as "M/..". Documents issued in the WT/WGTI/W/- series are referred to as "W/..".

<sup>2</sup> As defined in a contribution by an intergovernmental organization, FDI is an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity of one country (the foreign direct investor or parent enterprise) in an enterprise resident in a country other than that of the foreign direct investor (foreign affiliate). W/8/Add.1, p.3

<sup>3</sup> Such contributions have been made by the OECD (W/8 and W/26), UNCTAD (W/8/Add.1), World Bank (W/8/Add.2), IMF (W/8/Add.3), and UNIDO (W/8/Add.4).

<sup>4</sup> Worldwide FDI flows increased from \$92.9 billion in 1983-1988 to \$349.2 billion in 1996 measured in terms of inflows and from \$93.7 billion in 1983-1988 to \$346.8 billion in 1996 in terms of outflows. W/8/Add.1, pp.29-30

- A notable aspect of this rise in FDI flows has been the recent increase in FDI flows to developing countries, both in total and as a proportion of global FDI.<sup>5</sup>
- FDI inflows to developing countries have been concentrated on a limited number of countries, but many developing countries have experienced significant increases of FDI relative to the size of their economies.<sup>6</sup>
- The relatively small volume of FDI flows to a large number of developing countries in Sub-Saharan Africa, South Asia, the Middle East and North Africa has been highlighted.<sup>7</sup>
- The surge of FDI flows in the 1990s has also been marked by the growing importance of developing countries as sources of outward FDI.<sup>8</sup>

6. Contributions by intergovernmental organizations point to the close relationship between the recent developments in the volume and pattern of FDI and the process of growing economic integration of the world economy. An increasing number of multinational enterprises are pursuing complex integration strategies that favour closely integrated production and distribution networks under which such firms engage in considerable cross-border specialization through a vertical and horizontal intra-firm division of labour across borders, including increasingly at the functional level.<sup>9</sup> Key points made in this connection are:

- The importance of the widespread liberalization of international trade and investment policies, improvements in transportation and communications technologies, and the growing role of knowledge and other specialized intangible assets in production and marketing as the principal factors explaining this development.<sup>10</sup>
- Empirical evidence cited has included the growing share of world output accounted for by cross-border production by multinational affiliates, the increasing orientation of overseas production by multinational affiliates towards exports rather than the domestic market of the host country, the increasing importance of intra-firm trade in world trade, and growing international out-sourcing.<sup>11</sup>
- The expansion of the participation in this international organization of production of developing countries, where the average share in GDP accounted for by the affiliates of multinationals has increased particularly rapidly in recent years (from 4.3 per cent in 1992 to 6.3 per cent in 1995).<sup>12</sup>

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<sup>5</sup> FDI inflows to developing countries rose from an average of \$20 billion annually during 1983-88 to an average of \$95 billion in 1994-1995, to reach \$129 billion in 1996. The share of all developing countries in worldwide FDI flows rose from 21.6 per cent in 1983-88 to 36.9 per cent in 1996. W/8/Add.1, p.29

<sup>6</sup> In the five most recent years for which data were available, the leading ten non-OECD recipients of FDI accounted for three quarters of total flows to non-OECD countries (W/8, p.4). However, the simple average of FDI to GDP ratios for low and middle income countries nonetheless doubled between 1990 and 1994. W/8/Add.2, p.10

<sup>7</sup> W/8/Add.1, p.7; W/8/Add.2, pp.19-20; W/8/Add.4, p.7

<sup>8</sup> The share of worldwide FDI originating in developing countries rose from 3 per cent in 1980 to 15 per cent in 1996. Most of the outflows from developing countries are accounted for by countries in East Asia, but such outflows are increasingly important also in other regions, notably Latin America (W/25).

<sup>9</sup> W/8/Add.1, p.4

<sup>10</sup> W/8/Add.2, pp.5-8; W/8/Add.4, p.5

<sup>11</sup> W/8/Add.2, pp.8-12. An analysis of the growing internationalization of production in some major industrial sectors is contained in W/8, Annex 1.

<sup>12</sup> W/8/Add.2, p.8

7. A common theme in the contributions by the intergovernmental organizations is that the link between FDI and the growing integration of the world economy has important implications for the analysis of the relationship between FDI and development. The main points that have been made in this connection are:

- The enhanced opportunities for countries to benefit from closer integration in the international economy and the key role FDI can play in improving the capacity of a host economy to respond to such opportunities. As FDI is increasingly oriented towards the cross-border integration of value-added activities by multinational enterprises<sup>13</sup>, countries can participate in global production by mastering a slice of the value-added chain in a given industry rather than waiting to master all the different stages, resulting in a wider range of options for production and trade.<sup>14</sup>
- The greater emphasis placed by host countries on the benefits to be derived from the intangible assets associated with FDI, such as technology, the stimulus that FDI often gives to competition and increased efficiency, and its role in promoting integration in the world economy, as compared to the contribution of FDI to capital formation, tax revenue and balance of payments.<sup>15</sup>
- The increasing importance of factors such as technological capability, human skills, quality of infrastructure and openness of trade policies as determinants of inward FDI as compared to factors such as size of domestic markets and the availability of natural resources.<sup>16</sup>

8. Several contributions by intergovernmental organizations draw attention to the relatively low level of FDI inflows to many developing and least developed countries. However, they also point out that, although such FDI flows may be relatively small in absolute terms, they are not necessarily small in relation to the GDPs and gross domestic capital formation of the countries concerned. For example, inflows into African countries as a whole, relative to African GDP, are about the same order of magnitude as flows to developed countries.<sup>17</sup> Moreover, the point has been made that the ratio of FDI to GDP increased in the first half of the 1990s in every region except East Asia, where it was already high.<sup>18</sup>

9. Members, in their written contributions and in discussions at the meetings of the Working Group, have generally endorsed the above-mentioned analysis of the implications for the relationship between FDI and development of the changing global environment. Points that have been emphasized in this respect include the shift in attitudes of many developing countries towards a recognition of the positive contribution of FDI; the growing importance to host economies of FDI as a vehicle for the transfer of intangible assets and as a means of greater integration into the world economic system; the increasing competition among countries to attract FDI; and the declining importance of market size and natural resources as determinants of the location of FDI, as compared to technological capability, human resource development and other created assets that affect the competitiveness of countries.<sup>19</sup> The need to pay special attention to the situation of the least developed countries has also been stressed.<sup>20</sup>

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<sup>13</sup> W/8/Add.1, pp.3-4

<sup>14</sup> W/8/Add.1, p.4.; W/8/Add.2, p.13; W/26, pp.4-5

<sup>15</sup> M/2, paragraphs 4-5

<sup>16</sup> W/8/Add.2, pp.19-20 and p.26; W/8/Add.4, p.3

<sup>17</sup> W/8/Add.1, p.7

<sup>18</sup> W/8/Add.2, p.9

<sup>19</sup> M/2, paragraphs 11 and 12

<sup>20</sup> M/2, paragraph 14

10. In the discussions in the Working Group and in some contributions, it has been argued that the changing international economic environment means that caution should be exercised in drawing lessons from the restrictive FDI policies pursued by some relatively more advanced countries at earlier stages of their development. In particular, the points have been made that the accelerating pace of technological change means that such policies, if pursued today, would deprive countries of the vital technological spillover accompanying foreign capital, leading to a weakness in the competitiveness of domestic industries, as well as have a negative effect on trade given the increasingly important role that multinational corporations play in world trade.<sup>21</sup> Some other Members have indicated that, nonetheless, they believe that it is important to study the experience of these countries, while taking account of the changed economic environment. These issues are further treated in section V of this Note.

### III. EFFECTS OF INWARD FDI ON ECONOMIC DEVELOPMENT

11. This section looks at the effects of inward FDI on development in terms, successively, of its impact on capital formation, the transfer of technological and other know-how, access to export markets, domestic entrepreneurship and industry, competition, employment and the balance of payments and macroeconomic stability. The point, however, is made in a contribution by an intergovernmental organization that one of the defining characteristics of the multinational enterprise is that it embodies and organizes as a single package a range of factors of production - labour, capital, technology and accumulated management and marketing expertise - and that a common view of the multinational enterprise is that the whole is greater than the sum of its parts.<sup>22</sup>

#### III.1 Capital formation

12. By way of background to the role of FDI as a source of development finance, several contributions by intergovernmental organizations point to the reversal since the mid-1980s in the overall composition of capital flows to developing countries between private and public flows: FDI and other private capital flows now account for some three quarters of net resource flows to developing countries whereas in the 1980s they represented one third of those flows.<sup>23</sup> Data on total net resource flows from OECD countries to developing countries show that, while FDI flows to developing countries have increased greatly, their share in total flows has remained static at some 20 per cent, with the largest increases being in international bank lending and bond issues.<sup>24</sup>

13. Data contained in the contributions by intergovernmental organizations show that the share of FDI in capital formation in developing countries has increased<sup>25</sup>, and that FDI accounts for a significantly greater share of capital formation in developing countries than in developed countries.<sup>26</sup> At some 8.2 per cent (in 1995), FDI makes a significant contribution to the gross fixed capital formation of developing countries and, in some individual countries, a major contribution.<sup>27</sup> The point has been made that, nonetheless, the bulk of both domestic industrial investment as well as other investment in developing countries has to be financed predominantly from domestic sources.<sup>28</sup>

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<sup>21</sup> See the contribution by Japan (W/18, p.2).

<sup>22</sup> W/26, p.30

<sup>23</sup> W/8, p.7; W/8/Add.4, p.3

<sup>24</sup> W/8, p.8

<sup>25</sup> FDI was 5-6 per cent of aggregate investment in developing countries in the early 1990s, compared to the 1-2 per cent of the previous fifteen years. W/8/Add.2, pp.13-14

<sup>26</sup> The ratio of FDI inflows to gross fixed capital formation in developing countries in 1995 was 8.2 per cent as compared to 4.4 per cent in developed countries. W/8/Add.1, p.5

<sup>27</sup> For example, in China FDI accounted for over one third of gross domestic investment in 1994. W/8/Add.2, p.14

<sup>28</sup> W/8/Add.4, p.4

14. The contributions from intergovernmental organizations make the point that FDI, even if often a relatively minor part of capital formation and capital imports, is a particularly valuable part. This is not only because it frequently carries with it a range of intangible assets that have important positive spillovers for the rest of the economy (points discussed in later subsections), but also because of its financial characteristics. Although FDI appears as just another capital flow in the balance of payments, it differs from other capital flows in important respects: FDI involves more stable and smaller amounts of capital than other types of capital flows, does not create obligations for debtors to make fixed interest payments and to reimburse the principal at a determined date, and contributes more to the financing of productive investment than other capital flows.<sup>29</sup>

15. Several contributions examine and reject the argument that FDI may simply substitute for domestic investment and thus does not contribute to an expansion of the capital stock in host countries. The point is made that such empirical evidence as there is on this relates to investment inflows generally and not specifically to FDI. FDI is less likely than other capital inflows to encourage domestic consumption and reduce domestic investment through its impact on the exchange rate and prices of stocks and real estate. It is pointed out that countries where FDI dominates capital inflows have experienced more significant increases in total investment than countries where capital inflows have mostly been of the financial variety.<sup>30</sup> Reference has also been made to empirical studies that show that FDI not only does not substitute for domestic investment but may lead to additional domestic investment.<sup>31</sup>

16. One contribution questions the view that FDI is likely to have more favourable effects on capital formation if it is in the form of greenfield investments than that of mergers and acquisitions. This is not only because the proceeds from such mergers and acquisitions will often be used to make other investments, either of a financial or real nature, but also because the merger or acquisition will, more often than not, be followed by sequential FDI, in modernization and capacity expansion, which may well be larger than the original purchase.<sup>32</sup> Indeed, several contributions by intergovernmental organizations as well as by Members stress the importance of the capital contribution of FDI in the context of infrastructure privatization and modernization.<sup>33</sup> It has been estimated that FDI inflows accounted for more than half of infrastructure privatization revenues in developing countries from 1988 through 1995.<sup>34</sup>

17. The significant role of FDI in capital formation in host countries is emphasized in several contributions by Members, although they also stress the value of the flows of the intangible assets associated with FDI.<sup>35</sup> Reference has also been made to the preference for FDI over other sorts of foreign capital inflows, not only because of the associated intangibles but also because it is less likely to create repayment and balance-of-payments problems.<sup>36</sup>

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<sup>29</sup> W/8, p.21

<sup>30</sup> W/8/Add.1, p.15

<sup>31</sup> W/8/Add.2, p.14

<sup>32</sup> W/8/Add.1, pp.15-16

<sup>33</sup> W/8/Add.1, p.16

<sup>34</sup> W/8, p.9. A detailed analysis of the experiences of individual countries in Latin America and South East Asia with respect to the role of FDI in privatization is contained in the OECD study on Foreign Direct Investment and Economic Development. W/26, pp.16-20

<sup>35</sup> See, for example, the contributions by Japan (W/11, p.4); Colombia (W/15, p.1); Korea (W/16, pp.3-4) and Bolivia (W/20, pp.1-2).

<sup>36</sup> M/4, paragraph 12

### III.2 Technological and managerial know-how

18. Several of the contributions of intergovernmental organizations, as well as that of the WTO Secretariat, recall that a fundamental feature of the multinational corporation is its ownership of specialized intangible assets related to technological and management know-how. Given that such assets are often not easily exploitable by the company which controls them through contractual arms-length relationships, the exploitation of them in foreign markets is frequently carried out through FDI. However, the value of such assets remains imperfectly appropriable even in an FDI context and their transfer to foreign affiliates usually generates important positive spillover effects for the host economy at large.<sup>37</sup>

19. The intangible assets in question, here summarized as "technological and managerial know-how", are diverse, ranging from technology that is the subject of intellectual property titles, through related technical know-how and human skills to managerial and marketing techniques.

20. The contribution that FDI makes to the transfer and diffusion of such intangible assets is considered in the papers presented by intergovernmental organizations to be possibly the most important contribution that FDI makes to the development of host countries, especially developing countries. In this connection, attention is drawn to the concentration of technology and other know-how within multinational enterprises and the relative backwardness of many developing countries in this area of critical importance for economic development.<sup>38</sup> The observation is made that FDI has become more prominent relevant to other modalities of technology transfer.<sup>39</sup>

21. Two main types of contribution to development are identified in the contributions:

- first, those which flow from the introduction and use by the investor of the technology and know-how itself;
- second, the spillovers or externalities to other parts of the host economy which result.<sup>40</sup>

22. The indirect benefits or spillovers have been identified as follows:

- Labour market spillovers. The diffusion of technical and managerial skills as employees trained by the foreign investor move to other parts of the domestic economy.
- Supplier spillovers. These result from the collaboration of the foreign affiliate with local suppliers, especially on such matters as product design, technical support, production process planning and quality control. Several of the contributions report on empirical work which indicates the prevalence of such forms of cooperation between affiliates of multinationals and their domestic subcontractors.<sup>41</sup>
- The stimulation of domestic innovation. The point is made that domestic innovation depends on the number of ideas available in the economy. Thus the introduction of new ideas increases the stock of ideas and stimulates domestic innovation.<sup>42</sup>

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<sup>37</sup> W/8/Add.1, pp.3 and 16-17; W/8/Add.2, pp.4, 7; W/7, pp.8-9; W/26, p.30

<sup>38</sup> W/8/Add.1, p.17; W/26, p.35

<sup>39</sup> W/8/Add.4, p.5

<sup>40</sup> W/8/Add.1, pp.17-18; W/8/Add.4, pp.5-6

<sup>41</sup> W/8/Add.1, p.19; W/8/Add.2, pp.14-15

<sup>42</sup> W/8/Add.1, p.17

23. Significant differences have been noted between countries regarding the extent to which they have relied on FDI as a mode of transfer of technology.<sup>43</sup> In this connection it is noted that, contrary to what neo-classical models postulate, technology is not a free good that is clearly specified and readily available for use by any firm anywhere, but, in important respects, technological assets contain a tacit element that is not easily transmittable or replicable in another environment. Further, the observation is made that technology markets are opaque and subject to informational failures.<sup>44</sup> In discussing whether it is preferable to obtain technology through FDI, including joint ventures, as compared to other means, such as licensing, it is argued that much depends upon whether the technology in question is available in a more unpackaged form than through FDI, which is not always the case, and upon the availability in the host country of entrepreneurial and technical skills to operate new technologies and earn profits doing so.<sup>45</sup>

24. The contributions by intergovernmental organizations identify several kinds of factors that affect the extent to which FDI contributes to the transfer and diffusion of technical and other know-how in host countries:

- First, the technical competence and learning ability of host countries and the level of local recruitment in key technical and management positions.<sup>46</sup>
- Second, evidence has been adduced demonstrating that more competition in host country markets increases the pressures on and incentives for multinational enterprises to transfer more and better quality technology to their affiliates.<sup>47</sup> More specifically with respect to trade policy, it has been noted that import substitution policies may enable multinational enterprises to undertake market-seeking investments that fail to incorporate state of the art technologies, whereas export-oriented policies, under which production has to be internationally competitive, are more likely to encourage the introduction of the most advanced technology.<sup>48</sup> In the latter regard, the point has also been made that technology transfer may be limited when export production takes place in enclaves that have no linkages with domestic enterprises.<sup>49</sup>
- Third, on the basis of empirical studies, some contributions call into question the effectiveness of specific host country policies designed to augment the transfer of technology, such as requirements to operate through joint ventures with local firms, mandatory transfers of technology and compulsory licensing.<sup>50</sup>

25. The contribution of an intergovernmental organization discusses concerns regarding the accentuation of structural heterogeneity in host countries that may result from foreign affiliates and domestic firms with links to multinational enterprises increasing their technological lead over small and medium-sized domestic enterprises and points to the case for active government policies to overcome the relative backwardness of small and medium-sized enterprises.<sup>51</sup> This concern is endorsed in the contribution of a Member, which draws attention to the challenges that the growth of inward FDI by technologically advanced companies as well as increased trade liberalization poses for domestic companies who may find their technology rapidly rendered obsolete. It states that the

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<sup>43</sup> W/8/Add.1, p.17; W/8/Add.4, p.6

<sup>44</sup> W/8/Add.1, p.16; W/7, pp.8-9

<sup>45</sup> W/8/Add.1, pp.17-18

<sup>46</sup> W/8/Add.4, p.6

<sup>47</sup> W/8/Add.2, p.17

<sup>48</sup> W/8/Add.1, p.17

<sup>49</sup> W/26, p.36

<sup>50</sup> W/8/Add.2, pp.17-18; W/26, pp.35-36

<sup>51</sup> W/8/Add.1, p.18

effectiveness of the technological transformation process by these companies depends on their ability to acquire and develop technology from external sources on optimum terms, based on equitable and well-negotiated contracts, and the domestic technological support infrastructure.<sup>52</sup>

26. Contributions by Members endorse the idea that the contribution of FDI in the area of technical and other know-how is one of the key contributions that FDI can make to economic development of host countries.<sup>53</sup> Empirical evidence supporting the importance of the contribution of FDI to host country technological development is contained in a contribution by a Member which refers to national studies of technology transfer from parents to affiliates and technology diffusion arising from linkages between affiliates and local firms and from the research and development spending by affiliates.<sup>54</sup>

27. In discussions at meetings of the Working Group, Members have underlined the significance of the contribution of FDI in the area of technology transfer and diffusion and human resource development.<sup>55</sup> Support has been expressed for the observations made in some contributions by intergovernmental organizations regarding the impact of open trade policies on the quality of technology transfer and the counterproductive effect of certain policies aimed at regulating transfer of technology.<sup>56</sup> Attention has been drawn to the relationship between the role of FDI in the area of transfer of technology and the adequate protection of intellectual property rights.<sup>57</sup> It has also been argued that the potential beneficial impact of FDI on technological development of host countries is sometimes negated or limited by particular business practices, for example in the context of restrictive licensing arrangements between parents and foreign affiliates.<sup>58</sup>

### III.3 Access to export markets

28. Several of the contributions by intergovernmental organizations discuss the changing composition of FDI in developing countries from that which is motivated more by market-seeking considerations (often behind barriers to imports) to that which is more motivated by efficiency-seeking considerations, where the primary concern is to locate each stage of production or corporate function, for supply of the world or a regional market, in the country where it can be most efficiently undertaken due to the availability of relevant factors of production, such as natural resources, labour or technology.<sup>59</sup> The latter form of FDI offers more by way of facilitating access to export markets, both directly and indirectly, by host countries. Indeed, the point is made that it enables developing countries to participate in the international division of labour without having to master the technology involved in producing the complete product and has contributed importantly to the diversification of the exports of many developing countries which previously were focused essentially on primary products.<sup>60</sup> In this respect, a contribution makes the point that FDI can serve to integrate national markets into the world economy far more effectively than could have been achieved by traditional trade flows alone.<sup>61</sup>

29. It is also noted in the contributions by intergovernmental organizations that FDI has in some cases been importantly stimulated by the creation or development of regional economic integration arrangements, enlarging the "domestic" market and providing assurances of a host country's

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<sup>52</sup> See the contribution by Bolivia (W/20, p.4).

<sup>53</sup> See the contributions by Poland (W/13, p.3), Colombia (W/15, p.1) and Bolivia (W/20, p.4).

<sup>54</sup> See the contribution by Korea (W/16, p.3).

<sup>55</sup> M/2, paragraph 14

<sup>56</sup> M/4, paragraph 9

<sup>57</sup> M/2, paragraph 16

<sup>58</sup> M/4, paragraphs 18-19

<sup>59</sup> W/8/Add.1, pp.9-11

<sup>60</sup> W/8, p.15; W/8/Add.1, p.4; W/8/Add.2, pp.4 and 13

<sup>61</sup> W/26, p.36

commitment to stable trading arrangements. Although such FDI is often primarily motivated by "market-seeking" considerations, it nonetheless frequently leads to increased trade within the region as a result of the restructuring of production on a regional basis.<sup>62</sup>

30. The papers presented by intergovernmental organizations indicate that the direct contribution of foreign investors to facilitating access to international markets by host countries derives not only from their role in dividing stages of production between countries and linking those stages through international trade flows, but also because of their international distribution channels for final goods and, in some cases, services produced by their foreign affiliates. Evidence is advanced to the effect that foreign firms, with their greater knowledge of world markets and access to international marketing channels, tend to be more involved in international trade than local firms.<sup>63</sup> Empirical evidence of the direct effect of FDI on export performance of host countries through the activities of foreign affiliates has been provided through data on the share of host country exports accounted for by foreign affiliates.<sup>64</sup>

31. The information supplied by intergovernmental organizations indicates that the contribution of multinational enterprises to host country export performance is not only a function of the exports realized by foreign affiliates, but is also indirect in that it stimulates exports by other companies in the host country. This is partly because linkages with the production and distribution networks of multinational enterprises that facilitate access to international markets may be established through a variety of contractual interfirm arrangements, such as subcontracting, licensing and production-sharing agreements.<sup>65</sup> In addition, the presence of export-oriented foreign affiliates has been shown to have demonstration and informational spillover effects which enhance the export performance of local firms in host countries.<sup>66</sup> The WTO Secretariat Note on "The Relationship between Trade and Foreign Direct Investment" also concludes, on the basis of a review of empirical studies, that inward FDI contributes to the export performance of developing countries both directly through multinational enterprises' own export activities and indirectly by reducing the costs and informational obstacles for domestic firms to start or expand exporting.<sup>67</sup>

32. Some of the contributions by intergovernmental organizations discuss the question of whether inflows of FDI might have a negative effect on overall exports by leading to an appreciation of the exchange rate. In general, they make the point that inflows of FDI are less likely to have such effects than inflows of other forms of foreign capital, because FDI inflows are frequently associated with counter-balancing outflows of foreign exchange to purchase capital equipment and supplies. However, one contribution suggests that excessive exchange rate appreciation could result from a sudden large increase of FDI into a small host country and argues that this may provide a rationale for phasing in FDI at a slower rate than the rate determined solely by market forces.<sup>68</sup>

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<sup>62</sup> W/8/Add.1, pp.9-10; W/8/Add.3, p.4; W/7, paragraphs 86-97; W/26, pp.14-16

<sup>63</sup> W/8/Add.2, p.14; W/7, paragraph 58

<sup>64</sup> Thus, one study reports that in 1994 US-owned foreign affiliates accounted for one tenth of the total exports in Argentina, Brazil, Chile, Indonesia, Malaysia and the Philippines and that, if other foreign affiliates are included, the foreign-owned share could exceed one half of the total exports for some countries. In certain sectors, such as electronics and computer chips, the share of exports represented by foreign affiliates sometimes exceeded 90 per cent (W/26, p.31). A study of FDI in China found that the share of foreign affiliates in exports increased from 17 per cent in 1991 to 31.3 per cent in 1995. W/8/Add.2, p.14

<sup>65</sup> W/26, p.32

<sup>66</sup> W/8/Add.2, p.14

<sup>67</sup> W/7 and Corr.1, paragraphs 10 and 56-60. (See also Job No 7172 which responds to comments made at the second meeting on the points made in W/7 on the link between FDI and export performance.)

<sup>68</sup> W/8/Add.1, pp.13-14

33. The contributions of a number of Members endorse, on the basis of their national experiences, the positive, direct and indirect, effects of inward FDI on the volume and structure of their exports.<sup>69</sup>

34. In discussions, some Members have emphasized the role of FDI in export growth and diversification and in improving the capacity of host countries to respond to the challenges of globalization.<sup>70</sup> Concern has been expressed about the danger that some developing countries might remain locations for simple assembly operations.<sup>71</sup>

#### III.4 Domestic entrepreneurship and linkages

35. The contributions by several intergovernmental organizations discuss the impact that FDI has on the development of indigenous entrepreneurial talents and domestic industry. On balance, they point to a generally positive impact. Most empirical studies point to positive spillovers for domestic industry.<sup>72</sup>

36. The channels through which FDI has positive impacts on domestic entrepreneurship and industry are identified in the contributions by intergovernmental organizations as follows:

- the domestic purchases of foreign affiliates from local suppliers, which tend to increase as companies gain experience in host environments<sup>73</sup>;
- the spillover effects of subcontracting arrangements with such suppliers (see paragraph 22 above);
- the generation of a local entrepreneurial class drawn from the ranks of the local partners of foreign investors and their managerial and skilled employees<sup>74</sup>;
- other spillover effects on the domestic economy from the training of manpower and diffusion of know-how, notably through the movement of personnel;
- lowering the price and increasing the quality and reliability of inputs used by domestic firms.<sup>75</sup> In this regard, evidence has been provided of the efficiency gains resulting from FDI liberalization in a range of infrastructure services<sup>76</sup>;
- as already discussed, through facilitating exports even by unrelated domestic firms.

37. Some of the contributions note that it has sometimes been argued that in certain situations FDI may have a "crowding out" effect on domestic firms in those sectors of the economy where foreign investment takes place.<sup>77</sup> The point is made, however, that the results of policies to favour domestic entrepreneurship have not always been positive, in that domestic entrepreneurship did not fare well even though FDI was discouraged and that today the constraint is mostly one of the domestic availability of human resources and entrepreneurial talents. One of the contributions also discusses a more general "crowding out" effect that could arise if large foreign firms are able to borrow on

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<sup>69</sup> See the contributions by Japan (W/11, pp.2-3), Poland (W/13, p.3), Korea (W/16, p.5) and Costa Rica (W/31, pp.2-3).

<sup>70</sup> M/4, paragraph 9

<sup>71</sup> M/4, paragraph 18

<sup>72</sup> W/8/Add.2, p.15; W/8/Add.1, p.20

<sup>73</sup> W/8/Add.1, p.19

<sup>74</sup> W/8, p.14

<sup>75</sup> W/8/Add.1, p.19

<sup>76</sup> W/8/Add.2, p.16; W/26, pp.25-30

<sup>77</sup> W/8, p.14; W/8/Add.1, pp.18-19

domestic financial markets, raising domestic interest rates and reducing the profitability of investment projects for small and medium-sized domestic firms without access to international capital markets. It argues that this is a possible rationale for monitoring the domestic borrowing of large foreign firms.<sup>78</sup>

38. The point is made in some contributions that the extent of the linkages that may stimulate economic activity in other parts of the economy will depend on the nature of the FDI, for example such linkages are more likely to be generated when FDI is in the manufacturing or services sectors than in natural resources, particularly mining.<sup>79</sup>

### III.5 Competition

39. Two main aspects of the relationship between FDI and competition have been raised in the contributions by international organizations: first, the impact of FDI on the degree of competition in host countries and, second, the importance of policies that enhance the degree of competition in host country markets in maximizing the gains from FDI.

40. Contributions by several international organizations point out that the entry of new competitors through FDI can enhance competition and efficiency in the domestic market of host countries not only by introducing a new competitor in many cases but also by prompting domestic firms to adjust to remain competitive. Empirical evidence has been referred to showing that the entry of multinational enterprises into an industry has had a positive effect on the productivity of domestic firms in a number of countries.<sup>80</sup>

41. However, some contributions from intergovernmental organizations also indicate that there may be situations in which FDI can lead to greater concentration and reduce competition in host country markets.<sup>81</sup> An example that has been mentioned in one of these contributions is FDI in the form of the acquisition of a domestic producer by a foreign producer already exporting into the market of the host country.<sup>82</sup> Another contribution points out that multinational enterprises by their very nature operate in concentrated industries and that they may wind up displacing smaller and less efficient domestic firms, rather than prodding them to increase their efficiency. According to this contribution, the risk of monopolization may be particularly acute in some non-tradable services, where the option of liberalizing imports in order to check the monopoly power of producers is not technically feasible.<sup>83</sup>

42. A second aspect of the relationship between FDI and competition that has been raised in the contributions by intergovernmental organizations is that host countries can maximize the gains from FDI by adopting policies to enhance the level of competition in domestic markets. As previously noted, empirical studies referred to in some contributions show that the incentive to transfer more advanced technology to affiliates is influenced by the degree of competition in host country markets.

43. In regard to any anti-competitive practices of multinational enterprises, the view has been expressed in the contributions by intergovernmental organizations that, since anti-competitive practices are not unique to foreign firms, the appropriate response to such practices lies in the non-discriminatory enforcement of competition policies in host countries, with the cooperation of other competition authorities where necessary, rather than in specific restrictions of FDI. It is noted that the presence of foreign firms in a domestic market may complicate the task of the national competition

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<sup>78</sup> W/8/Add.1, p.19

<sup>79</sup> W/8/Add.1, p.19

<sup>80</sup> W/8/Add.1, p.20

<sup>81</sup> W/8, p.19; W/8/Add.1, p.20

<sup>82</sup> W/8, p.19

<sup>83</sup> W/8/Add.1, p.20

authority, particularly if cartel activity is suspected, as information necessary to the investigation of the practice may be spread across the jurisdiction of several countries. It is further suggested that the removal of any remaining restrictions on the entry of foreign firms as well as of barriers to trade in the sectors in question can greatly help the task of national competition agencies in this regard as the entry of additional firms is the best long-term strategy to prevent the acquisition of excessive market power.<sup>84</sup> In regard to certain service sectors, characterized by "natural" monopoly conditions, the point has been made that, to realize the potential benefits of increased competition generated by FDI, it may be necessary to establish an adequate regulatory framework.<sup>85</sup>

44. A contribution by a Member refers to the promotion of domestic competition and productivity as an explicit objective of its FDI policies. It points out that inward FDI is expected to enhance efficiency by inducing specialization of local companies, reducing the concentration of economic power and facilitating the exit of less competitive companies from markets.<sup>86</sup> The contribution of another Member draws attention to competing views that have been advanced on the effect on competition of certain restrictive FDI policies pursued by its government in the post-war period.<sup>87</sup>

45. In meetings of the Working Group, it has been argued by some Members that anti-competitive effects on host country economies may sometimes arise from particular practices and business strategies of multinational firms. For example, foreign affiliates might be prevented from undertaking certain activities by their parents, for example exporting, including by restrictions in transfer of technology arrangements. Concern has also been expressed about possible political interference by foreign affiliates, for example to seek protection from competition.<sup>88</sup> A Member has stated that its experience was that anti-competitive practices were not typical of foreign firms and wondered if there was evidence to the contrary. In its view, the non-discriminatory application of competition law was the appropriate remedy.<sup>89</sup>

46. A contribution by an intergovernmental organization discusses possible concerns regarding transfer pricing. It argues that the danger of transfer pricing has diminished as foreign exchange constraints in developing countries have eased and corporate taxes have fallen but that the issue still merits attention insofar as the ability of multinational firms to extract their profits from host countries via intra-company transactions at artificial prices may reduce the benefits of FDI to host countries. It makes the point that bilateral double taxation treaties may go a long way towards resolving this problem by removing the incentive for abusive transfer pricing except where, as is the case in some developing countries, corporate taxes are higher in host countries than in home countries. It states, furthermore, that double taxation treaties are not an effective remedy where profits are channelled through tax havens. It suggests that the issue of transfer pricing needs to be followed closely at the national and international levels and emphasizes the importance of developing country legislation including clear accounting rules on this matter.<sup>90</sup> Another contribution by an intergovernmental organization also suggests that policy-makers may wish to consider greater international coordination in setting national policies and standards in this area.<sup>91</sup>

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<sup>84</sup> W/8, p.19

<sup>85</sup> W/8/Add.2, pp.18-19

<sup>86</sup> See the contribution by Korea (W/16, p.4).

<sup>87</sup> See the contribution by Japan (W/18, p.2).

<sup>88</sup> M/4, paragraphs 18-20. One of the documents before the Working Group contains a report on a debate held in the context of the UNCTAD Commission on Investment, Technology and Related Financial Issues at its second session (29 September-3 October 1997) as to whether or not liberalization of investment policies needs to be accompanied by implementation of competition policies. See W/21, pp.45-47.

<sup>89</sup> M/4, paragraph 22

<sup>90</sup> W/8/Add.1, pp.14-15

<sup>91</sup> W/8/Add.2, p.21

### III.6 Employment

47. With regard to the contribution of FDI to employment in host countries, the contributions by intergovernmental organizations make a distinction between a direct effect, which relates to the number of persons employed by foreign affiliates, and an indirect effect, which arises from the purchase by foreign affiliates of goods and services from local firms and from the contribution of FDI to the economic growth of host countries. While quantitative estimates have been provided of the direct employment effect of FDI in a number of countries<sup>92</sup>, it has been pointed out that the indirect employment effect may be greater and longer lasting.<sup>93</sup>

48. It is pointed out in a contribution that the employment effects of FDI vary by sector of economic activity and that, while significant direct employment effects arise from FDI in export-oriented, labour-intensive activities, FDI in capital-intensive activities, such as mining, has limited direct effects on employment.<sup>94</sup>

49. Some written and oral contributions by Members, discussing the employment effects of inward FDI in their countries, point to a positive relationship between inward FDI and employment creation.<sup>95</sup>

50. Several contributions by intergovernmental organizations point out that foreign affiliates tend to pay higher wages than local firms.<sup>96</sup> One contribution observes that there is little information on the impact of FDI on income distribution in host countries but that one can speculate that, if FDI leads to the introduction of new skills or to the training of human resources, it is likely that it will make income distribution in developing countries less unequal given that the accumulation of human capital has an equalizing effect on income distribution. The effect of FDI on income distribution varies by sector and on the whole may not be very significant, except in countries where FDI is large relative to the size of the economy.<sup>97</sup>

### III.7 Balance of payments and macroeconomic stability

51. A contribution by an intergovernmental organization makes the general observation that the issue of the balance-of-payments effects of FDI, once a prominent theme in the literature on FDI in the 1970s mainly because most developing countries faced a binding foreign exchange constraint to growth, is now less pressing as, in the present times of much higher international capital mobility, growth in developing countries is not as constrained by foreign exchange availability as it was in the 1970s and 1980s. It adds, however, the point that this does not mean that balance-of-payments effects are unimportant for all countries or that they could not become important again in the future.<sup>98</sup> Another contribution questions the continued relevance of the results of earlier studies that had found negative balance-of-payments effects of FDI in some developing countries in the light of the recent shift from import-substituting to export-promoting development strategies and refers to more recent studies that show positive balance-of-payments effects of FDI.<sup>99</sup>

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<sup>92</sup> See, for example, the figures on employment by foreign affiliates in W/8/Add.2, p.14 (China), W/26, p.34 (Brazil, Argentina, Chile, Indonesia, Malaysia and the Philippines) and W/16, p.2 (Korea).

<sup>93</sup> One contribution refers to a study which estimates that for every job created by foreign investors another 1.6 jobs are generated in the rest of the economy. W/26, p.34

<sup>94</sup> W/8/Add.1, p.20

<sup>95</sup> See, for example, the contributions by Korea (W/16, p.2) and Costa Rica (W/31, p.2), and M/3, paragraph 6.

<sup>96</sup> W/8/Add.2, p.14; W/26, p.34

<sup>97</sup> W/8/Add.1, pp.20-21

<sup>98</sup> W/8/Add.1, p.13. A detailed analysis of the balance-of-payments effects of FDI is contained in the UNCTAD *World Investment Report 1997*, Chapter II.

<sup>99</sup> W/26, p.33

52. In discussing factors that are relevant to an assessment of the balance-of-payments implications of inward FDI, contributions by intergovernmental organizations point out that:

- The balance-of-payments impact of an investment project cannot be assessed only by comparing the inflow of foreign exchange associated with an investment project with the present value of future outflows of profits. Account should also be taken of other effects, such as the generation of exports or the saving of foreign exchange by substituting domestic production for imports. The point is made that the effect on the capital account, which results from the repatriation of profits once the affiliate has become profitable, is likely to be mirrored by a positive effect on the trade balance as the project becomes less dependent upon imported components over time and, in the case of export-oriented projects, exports will come to represent a substantial share of the output. The net effect on the balance of payments from these offsetting current and capital account flows is difficult to determine *a priori*.<sup>100</sup>
- FDI most often takes the form of equity capital, which, as opposed to debt-creating instruments, imposes no obligations on the debtor to make fixed interest payments and to reimburse the principal at a determined date. Rather, FDI contributes to the financing of productive investments in a higher proportion overall than portfolio investment and credits, thereby enhancing the host country's capacity to assure the service of its debt through increased exports at a later stage.<sup>101</sup>
- The balance-of-payments effects of FDI cannot be properly assessed by limiting the analysis to individual investment projects. FDI is a continuous process in that, as some older investors begin to repatriate profits, new investors inject equity capital into the host country and existing investors expand their presence through retained earnings. In addition, to focus only on the direct balance-of-payments effects of the activities of foreign affiliates ignores the indirect contribution of FDI to the overall export potential of the host country and its economic growth.<sup>102</sup>
- The impact of FDI on the balance of payments is inherently difficult to determine in the absence of knowledge of the most likely counterfactual.<sup>103</sup>

53. Several contributions by Members discuss the relationship between FDI and the trade balance of host countries. Some Members have shared the view that, in the present environment of more export-oriented FDI, flexible exchange rates and mobile capital, the analysis of FDI in terms of its effects on the trade balance and balance of payments was no longer a key policy issue.<sup>104</sup> One Member's contribution refers to research showing that its outward FDI to a number of developing countries had a positive impact on the trade balance of these host countries.<sup>105</sup> A contribution by another Member contains data demonstrating the positive effect of inward FDI on the trade balance of that Member.<sup>106</sup> The possibility of a negative effect of FDI on the trade balance and the balance of payments of host countries has been mentioned in general terms in a contribution by a Member which states that, at the initial stage of FDI, imports from a host country are likely to increase and that in the mid- and long term the repatriation of profits from foreign subsidiaries to a home country may have adverse effects on the balance of payments of a host country.<sup>107</sup> At the meetings of the Working

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<sup>100</sup> W/26, p.32

<sup>101</sup> W/8, p.21

<sup>102</sup> W/26, pp.32-34

<sup>103</sup> W/8/Add.1, p.13

<sup>104</sup> M/3, paragraph 21; M/4, paragraph 17

<sup>105</sup> See the contribution by Japan (W/11, pp.2-3).

<sup>106</sup> See the contribution by Korea (W/16, p.5).

<sup>107</sup> See the contribution by Japan (W/11, p.5).

Group, this Member has stressed that this point is based on theoretical reasoning and not on its own experience or empirical studies.<sup>108</sup>

54. In regard to the relationship between FDI and the macroeconomic stability of host countries, a contribution by an intergovernmental organization discusses the concern that large capital inflows may complicate the conduct of monetary and exchange rate policies by causing an appreciation of the exchange rate and that excessive reliance on external financing may make an economy vulnerable to sudden reversals in financial market conditions and in foreign investor sentiment. It argues that evidence suggests that FDI is less likely to raise such problems than other types of capital flows because it involves much more stable and generally smaller amounts of capital than portfolio investments and credits.<sup>109</sup>

55. A contribution by an international organization discusses concerns about a possible destabilizing effect of FDI liberalization in financial services. It makes the point that allowing greater foreign participation in domestic financial service sectors helps reduce the risk of banking crises in host countries by enhancing competition and efficiency and improving the quality of banking regulation. To illustrate these benefits, it refers to the stabilizing role of the presence of foreign banks in the recent financial crisis in Argentina<sup>110</sup>, a view supported by the representative of that country.<sup>111</sup>

56. In meetings of the Working Group, some Members have endorsed these views.<sup>112</sup> Some others mentioned the possible adverse implications of FDI in the context of the recent experience of some countries in South East Asia. The Working Group has been informed of the results of a study undertaken by UNCTAD of actual and prospective FDI flows to the countries most affected by the Asian financial crisis, which confirms the greater stability of FDI flows compared to other capital flows.<sup>113</sup>

#### IV. EFFECTS OF OUTWARD FDI ON DEVELOPMENT

57. As previously noted, one significant feature of recent trends in FDI flows is the substantial increase in the share of global outward FDI flows accounted for by developing countries, from 3 per cent in 1980 to 15 per cent in 1996.<sup>114</sup> A Note by the WTO Secretariat on outward FDI from developing countries notes that outward FDI tends to increase with the level of development.<sup>115</sup> Outward FDI from developing countries tends to be oriented towards countries within the same region although there are some notable exceptions, for example outward FDI from Korea and Chinese Taipei in developed countries. The Note by the Secretariat concludes, on the basis of a review of FDI from each of the largest outward investors in Asia, that the factors explaining such FDI are largely the same as for outward FDI from developed countries. Thus, vertical outward FDI from developing countries is driven by cost and efficiency factors, while horizontal outward FDI appears to be motivated by the effect of trade protection in host countries.

58. Contributions to the Working Group do not provide a comprehensive analysis of the impact of outward FDI on the growth and development of developing home countries. A contribution by an intergovernmental organization discusses concerns about possible negative effects of outward FDI on jobs and wages in home countries on the basis of the experience of developed countries in this regard.

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<sup>108</sup> M/4, paragraph 19

<sup>109</sup> W/8, p.21

<sup>110</sup> W/26, p.27

<sup>111</sup> M/4, paragraph 11

<sup>112</sup> M/4, paragraph 9

<sup>113</sup> M/4, paragraph 23

<sup>114</sup> W/25, p.1

<sup>115</sup> W/25, p.2

It makes the point that available evidence indicates that these effects have been relatively minor, that outward FDI in the context of globalization generates higher trade and incomes at an aggregate level, which will have a positive indirect income effect on the demand for labour, and that outward FDI is a way for firms to remain competitive and hence to be able to maintain employment levels in the home country. It is suggested that FDI flows should be seen as part of the process of structural transformation of economies towards higher value-added activities. Reference is made to the deliberate policies in some developing countries to encourage some more labour-intensive activities to move abroad.<sup>116</sup> A contribution from a Member reports that a domestic survey of outward FDI found that the predominant effect on domestic employment was positive.<sup>117</sup> A contribution by another international organization points to the role of outward FDI from developing countries as a vehicle for transfer of technology to home countries, as illustrated by FDI from Korea and Chinese Taipei in the United States.<sup>118</sup>

59. Data contained in some contributions by Members point to a positive effect of outward FDI on the exports and trade balance of home countries although it is noted in one of these contributions that this effect may decline in the long term.<sup>119</sup> A contribution by a developing country Member describes the role of its outward FDI in establishing distribution channels for its exports.<sup>120</sup> Another contribution by a Member, based on a study of the pattern of parent-affiliate trade in the bilateral relationship between that Member and another Member, points out that parents have large surpluses with foreign affiliates, which confirms the complementarity of trade and outward FDI and home country exports.<sup>121</sup> At recent meetings of the Working Group, a Member has drawn attention to its experience regarding the beneficial effects of outward FDI in enhancing the competitiveness of firms and creating domestic employment.<sup>122</sup>

## V. POLICIES TOWARDS FDI HAVING A BEARING ON ITS IMPACT ON DEVELOPMENT

60. Two main issues have been discussed in relation to policies to FDI from a development perspective:

- First, what are the most appropriate policies in the current situation?
- Second, have the appropriate policies changed over time, in particular what lessons should be learnt from the experience of countries which adopted more restrictive policies at earlier stages of their development?

### V.1 Policies in the current environment

61. Contributions by intergovernmental organizations emphasize the importance of the regulatory environment in host economies as one of the key factors affecting both the volume of FDI received by a country and its contribution to development. This includes both policies relating specifically to FDI and policies affecting the wider environment for private enterprise activity including political and macroeconomic stability. One contribution illustrates the impact of host country regulation on the volume of FDI inflows by comparing the recent experiences of certain countries.<sup>123</sup>

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<sup>116</sup> W/8, pp.17-19

<sup>117</sup> See the contribution by the European Community and its member States (W/12, p.4).

<sup>118</sup> W/8/Add.4, pp.6-7

<sup>119</sup> See the contributions by Japan (W/11, p.2) and Korea (W/16, p.5).

<sup>120</sup> See the contribution by Cuba (W/35).

<sup>121</sup> See the contribution by the United States (W/14, p.61).

<sup>122</sup> M/3, paragraph 6; M/4, paragraph 14

<sup>123</sup> W/8/Add.2, pp.26-27

62. The contributions by intergovernmental organizations emphasize that, to be effective both in attracting FDI and in maximizing benefits from it, the liberalization of specific FDI legislation needs to be embedded in generic policy reforms designed to improve the overall environment for private sector activity by enhancing competition and efficiency in domestic markets. Country case studies illustrating this point have been provided or referred to.<sup>124</sup> The point has been made that these policies will stimulate not only FDI but also local entrepreneurship, which will in turn mean that FDI generates greater multiplier effects on the domestic economy.<sup>125</sup> Policy areas that have been identified in this connection as requiring attention include liberalization of payments and trade, adequate protection of property rights, privatization, deregulation or, where necessary, well-designed regulatory policies, competition policy, and, in general terms, a predictable institutional environment without excessive bureaucracy. Emphasis is also placed on the importance of general policies to improve the physical and social infrastructure and, in particular, the development of human skills.

63. The adoption of open trade policies has been viewed as being particularly important in generating conditions that will both be attractive to FDI and maximize benefits from it. The point has been made that policies pursued in the past by some developing countries to attract FDI on the basis of a protected home market have lost their effectiveness as they have run into market saturation and foreign investors have shifted to more dynamic countries and markets. Evidence has been presented showing that openness in terms of trade is positively related to the amount of FDI inflows and that the growth impact of FDI increases with the openness of the trade regime.<sup>126</sup> Thus, developing countries with more open trade policies tend to have a closer positive relationship between the presence of foreign firms and total factor productivity growth and the share of high-technology products in exports than countries with closed trade regimes.<sup>127</sup> The following main reasons have been put forward for this correlation between open trade regimes and beneficial FDI:

- trade liberalization makes domestic markets more dynamic, leading to higher growth and expansion of demand in host countries;
- the reduction of import barriers means that multinational enterprises can import better or lower-cost inputs, making export-oriented production viable;
- regional or multilateral agreements mean that such exports face fewer trade barriers abroad;
- trade liberalization reduces economic rents that can be captured by foreign investors and transferred abroad;
- it also encourages the transfer of the technology necessary for internationally competitive production.<sup>128</sup>

64. The contributions from intergovernmental organizations have also discussed the role of more specific investment policies, including the role of incentives:

- Some of the contributions by intergovernmental organizations urge a cautious approach to the use of incentives to attract FDI. One makes the point that empirical studies have consistently suggested that special tax and other fiscal incentives have little influence on FDI, although harmonization of corporate tax systems to

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<sup>124</sup> W/8, p.14; W/26

<sup>125</sup> W/8/Add.4, p.9

<sup>126</sup> W/7, paragraph 73; W/8, pp.14-15; W/8/Add.2, p.18; W/26, p.37

<sup>127</sup> W/7, paragraph 74; W/8/Add.2, p.18

<sup>128</sup> W/26; M/4, paragraph 8

best-practice standards is important, and expresses concern that beggar-thy-neighbour competition between countries to attract more FDI by offering larger tax breaks could lead to sub-optimal outcomes for all countries.<sup>129</sup> Another states that it is important to weigh the costs and benefits of investment incentives, consider possibilities of back-loading versus front-loading and ascertain as far as possible to what extent incentives actually make a difference in the locational decisions of multinational enterprises.<sup>130</sup> A further contribution warns against incentive policies that discriminate against domestic entrepreneurs, given the continuing predominant reliance on domestic investment and the importance of a dynamic domestic entrepreneurial community if the benefits from FDI are to be fully realized.<sup>131</sup>

- A contribution suggests that there is a role for pro-active policies aimed at attracting the kinds of investment that assist in moving up the quality ladder in a country's production structure and that promote export diversification, including FDI in industries with technological spillovers. This could be done through encouraging investment in certain activities (e.g. through tax rebates) or discouraging activities in some other sectors. Specific incentives could be offered for expenditures in areas that lead to important positive spillovers for the rest of the economy (e.g. training and R&D expenditures).<sup>132</sup>
- With regard to performance requirements, the point has been made that often they have been put in place in order to compensate for the negative consequences of trade protection and other policies that permit sub-optimal behaviour, from a welfare perspective, by foreign firms. Trade liberalization and other policies aimed at ensuring competitive markets called into question the rationale for such policies. Moreover, as FDI becomes more geared to internationally competitive production and competition for FDI increases, the ability of investors to afford and their willingness to countenance such requirements diminishes.<sup>133</sup> Evidence has been cited to the effect that performance requirements may have a counter-productive effect through driving away investors and discouraging the transfer of technology.<sup>134</sup>

65. A general point that has been made in some contributions by Members and by intergovernmental organizations is the importance of each country adopting policies towards FDI that take into account its own specific national characteristics and circumstances.<sup>135</sup>

66. In discussions in the Working Group, Members have generally endorsed the points made in the contributions by international organizations regarding FDI policies, notably in regard to the need for FDI liberalization to be an integral part of comprehensive economic market-oriented reforms and the importance of trade liberalization in promoting FDI inflows and enhancing the contribution of FDI to economic development.<sup>136</sup> Some Members have referred to the need to resist pressure sometimes exerted by multinationals for tariff and other forms of protection.<sup>137</sup> Some Members have referred to their own national experiences in relation to these matters.

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<sup>129</sup> W/8/Add.2, p.20. See also W/7, paragraphs 81-83.

<sup>130</sup> W/8/Add.1, p.22; M/4, paragraph 41

<sup>131</sup> W/8/Add.4, p.9

<sup>132</sup> W/8/Add.1, p.22

<sup>133</sup> W/26, p.5; M/4, paragraph 8

<sup>134</sup> W/8/Add.2, pp.17-18

<sup>135</sup> W/8/Add.1, p.22

<sup>136</sup> M/4, paragraphs 9 and 11-12

<sup>137</sup> M/4, paragraph 18

67. Some Members, while recognizing that FDI on the whole has a beneficial impact on development, have argued that there is a need for appropriate policies in order to minimize negative effects and maximize the gains from FDI. In the view of these Members, such policies should combine openness toward FDI with industrial policy, including sectoral targeting, which in their experience has proved to be an effective policy instrument and is distinguishable from the concept of infant industry protection.<sup>138</sup> A number of Members have been critical of the use of investment incentives and have indicated that their own experience calls into doubt the effectiveness of policies of sectoral targeting.<sup>139</sup> Another view has been that, while recognizing their limitations in relation to more fundamental economic factors and the need for moderation in their use to prevent inefficiencies, investment incentives can play an important role in compensating for domestic distortions, for example those arising from tax and labour laws, and in achieving sectoral objectives.<sup>140</sup>

## V.2 Have optimal policies changed over time?

68. In addition to the analysis and discussion of appropriate FDI policies summarized in the preceding paragraphs, there has been consideration of the historical evolution of FDI policies, in connection with which the question has been raised of the relevance in the current context of policies pursued by Members in the past. While the contributions by intergovernmental organizations do not, in general, address directly the points raised, they do contain relevant information describing the results of work on the reasons why policies towards FDI have changed, including because of changes in the global economic environment. Members in their written and oral contributions have also addressed these issues, directly or indirectly. The main points that have emerged are as follows.

69. In describing the evolution of their national policies towards FDI in the direction of greater openness, a number of Members have said that they believed that the present policies would be more effective in attracting FDI and yielding benefits for the development of their economies as a whole. They have made the point that the changes in investment policies have formed part of a wider package of policy changes, towards greater reliance on competitive market forces, which have, in their view, increased the benefits to be gained from an open FDI policy in their countries. Some of the contributions by intergovernmental organizations have provided a similar analysis of the evolution of national investment policies, including through the use of case studies. They have pointed to the declining effectiveness of policies aimed at attracting FDI to protected home markets and the limited contribution from such investment to growth and development.<sup>141</sup> A Member has said that one of the reasons for switching to a greater reliance on FDI was the repayment problems associated with its previous reliance on foreign public and commercial lending that it had experienced.<sup>142</sup> The point has been made that restrictive investment policies, including performance requirements, were sometime employed to limit the extent to which foreign companies could access and appropriate to themselves rents created through governmental protective and regulatory policies. With the reduction in barriers to trade and other policy adjustments aimed at more competitive and efficient markets, this rationale for such policies has been called into question.<sup>143</sup> These views have been endorsed by some Members in discussions in the Group.<sup>144</sup>

70. As indicated earlier in this Note, the contributions by intergovernmental organizations have also drawn attention towards the greater integration of the world economy as a factor to be taken into

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<sup>138</sup> M/4, paragraphs 18 and 21

<sup>139</sup> M/2, paragraph 29; M/4, paragraph 22

<sup>140</sup> M/4, paragraph 39

<sup>141</sup> W/8/Add.2, p.18; W/7, paragraph 74; W/26, p.5

<sup>142</sup> M/4, paragraph 12

<sup>143</sup> W/26

<sup>144</sup> M/4, paragraph 9

account in designing optimal FDI policies. A number of components of this have been particularly highlighted:

- One is the greater role of multinational enterprises in international trade, linked to the increasing tendency for foreign direct investment to involve a disaggregation of the production processes, especially in manufacturing, into stages that are located in different countries according to their comparative advantage. The main explanations given for this are the reduction in the worldwide barriers to trade and also to investment, as well as falling transport and communication costs.<sup>145</sup>
- A second factor is the growing importance of knowledge and other intangible assets in world production. Much of this know-how is in the hands of multinational enterprises who find it difficult to transfer and exploit through contractual arms-length relationships but more easily through FDI. Openness towards FDI, thus, is increasingly important as a vehicle for accessing such know-how and, given spillover effects, for its diffusion in the rest of the economy.<sup>146</sup>

71. The point has been made by Members in meetings of the Working Group that the above-mentioned changes in the global economic environment imply that restrictive policies pursued in the past by some countries would be counter-productive if applied in the present circumstances.<sup>147</sup> A Member which previously had restrictive policies towards FDI has expressed the view that, with the accelerated pace of technological innovation today, shutting out foreign capital from the market would also shut out any technological spillover accompanying that capital, leading to a weakening in the competitiveness of domestic industries. Furthermore, if the restrictive FDI policies that it employed earlier were to be used today, they would exert a much more negative effect on its trade. In addition, account should be taken of the vast increase in FDI in recent years; countries which had restrictive policies would deprive themselves of access to a much larger supply of capital today.<sup>148</sup> The view has also been expressed that the issue of whether certain policies used in the past are still relevant in the present context requires further analysis.<sup>149</sup>

## VI. CONCLUDING REMARKS

72. A broadly very positive picture of the impact of FDI on development emerges from the contributions by intergovernmental organizations summarizing the results of work done in their respective organizations. Emphasis is put on the bundle of productive assets that multinational enterprises are capable of deploying in host countries and, in particular, on the contribution made through the transfer and, as a result of spillover effects, the diffusion within their economies of technological, entrepreneurial, managerial and marketing know-how. Emphasis is also put on the role that FDI can play in facilitating the expansion of the exports of host countries and in enabling such countries to exploit the opportunities generated by the increasingly integrated world economy. Empirical evidence supporting the overall link between FDI and economic growth is cited in a number of the contributions of intergovernmental organizations.<sup>150</sup> Another point which emerges from the contributions of intergovernmental organizations is that FDI is not a zero sum game: the evidence points to it yielding benefits both to host countries and to home countries. A point that has been made is that FDI, although valuable, should not be considered a panacea that would solve the

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<sup>145</sup> W/8/Add.2, pp.5-6; W/8/Add.4, p.9

<sup>146</sup> W/8/Add.2, pp.6-8

<sup>147</sup> M/3, paragraph 5; M/4, paragraph 16

<sup>148</sup> W/18, p.2

<sup>149</sup> M/4, paragraph 20

<sup>150</sup> W/8/Add.2, p.15; W/8/Add.3, p.4; W/26, pp.36-37

problems of economic development by itself. These contributions also address the negative effects that FDI had, by some observers, been thought to have and which were used to justify the restrictive policies in some countries in earlier decades. They find these concerns largely unfounded, although the need for appropriate policies to deal with anti-competitive practices, transfer pricing problems and, in some circumstances, excessive exchange rate appreciation or crowding out of domestic entrepreneurs from domestic finance is referred to in one or more of the contributions.

73. This generally positive picture of the relationship between FDI and development has been endorsed by Members of the Working Group. Some, while agreeing that FDI has positive effects as a whole, have pointed to what they consider as possible negative aspects, or at least aspects that limit the benefits, such as restrictions on transfer of technology arrangements, the impact in certain situations on the balance of payments and the exchange rate, and the possible crowding out of domestic entrepreneurial activity. Some other Members have indicated that they have not experienced any negative aspects to inward FDI in their countries.

74. Another point which emerges strongly from the contributions of intergovernmental organizations and from the written and oral contributions of Members is the importance of the correct policy environment if the developmental benefits that can flow from FDI are to be fully realized. This encompasses the overall environment for private entrepreneurial activity, both domestic and foreign, including political, economic and financial stability and the proper functioning, at the micro level, of competitive domestic markets. Particular emphasis has been put on the importance of an open and stable trade regime and the need to resist pressure from investors for special favours, for example in the form of trade protection, has been mentioned. Emphasis has also been placed on the importance of policies to improve the physical and social infrastructure, in particular the development of human skills. In addressing possible negative effects, the importance of effective competition policies to deal with anti-competitive practices by both foreign and domestic companies has been widely emphasized. Some other Members have also referred to the areas where appropriate policies may be necessary that have been referred to in one or more contributions of the intergovernmental organizations. There has been a range of views expressed about the role of industrial policy incentives and sectoral targeting, with a view to maximizing benefits or mitigating possible negative effects. It has been suggested that there may be a case for enhanced international cooperation to address problems arising from transfer pricing, anti-competitive practices and the possible "beggar-thy-neighbour" use of investment incentives.

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