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Is Foreign Investment Always Good for Development

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Is Foreign Investment Always Good for Development?

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Abstract

In this paper, I explore the effects that FDI can have on domestic investment in recipient developing countries. An attempt is made to determine the circumstances under which FDI may be expected to induce additional investment from national firms, which is labelled as "crowding in" (CI). Under other circumstances, FDI may well displace investments that would have been made by domestic firms in the absence of the foreign investor ("crowding out", CO). A third possibility is that FDI may translate into real investment on a one-to-one basis, a situation I label as "neutral effect". Recent findings suggest that FDI over the period 1971 through 2000 has generally had neutral or CO effects on domestic investment. This means that a liberal policy toward FDI should be complemented with an effort to ensure that the recipient country attracts those investments that are more likely to maximize their investment rates.

Introduction

Foreign direct investment (FDI) is prized by developing countries for the bundle of assets that multinational enterprises (MNEs) deploy with their investments. Most of these assets are intangible in nature and are particularly scarce in developing countries. They include technology, management skills, channels for marketing products internationally, product design, quality characteristics, brand names, etc. In evaluating the impact of FDI on development, however, a key question is whether MNEs crowd in (CI) domestic investment (as, for example, when their presence stimulates new downstream or upstream investment that would not have taken place in their absence) or whether they have the opposite crowding out (CO) effect of displacing domestic producers or pre-empting their investment opportunities.

This is a rather important issue. In most theoretical and empirical work, investment has been identified as a key determinant of economic growth. Thus, if FDI crowds out (CO) domestic investment or fails to contribute to capital formation, there would be good reasons to question its benefits for recipient developing countries. Moreover, given the scarcity of domestic entrepreneurship and the need to nurture existing entrepreneurial talent, a finding that MNEs displace domestic firms would also cast doubts on the favourable development effects of FDI. These are all the more important questions when one considers that FDI is far from being a marginal magnitude. As can be seen in table 1, FDI, as a share of total gross fixed capital formation is a significant magnitude in developing countries. In fact, it is more important in most developing regions than in developed countries.

Table 1

FDI inflows as a percentage of gross fixed capital formation (percentage)

Region	2003	2004	2005
Developed countries	6.4	6.3	8.0
Developing countries	9.3	10.7	12.8
Africa	15.8	11.8	19.1
Asia	7.7	9.4	11.1
Latin America	13.5	15.9	16.8
Central and Eastern Europe	16.8	20.9	17.0

Source: UNCTAD (2006).

The Issues

Investment by MNEs contributes directly to investment, because it is part of it. Indeed, domestic investment (I_d) plus investments undertaken by MNEs (I_f) ought to add up to total gross investment (I).

$$I \equiv I_d + I_f$$

I_f is usually thought of as FDI. This formulation is, of course, an over-simplification, since FDI is not equivalent to new investments by foreign firms. FDI is a financial, balance-of-payments concept; on the other hand, investment is a real, national accounts variable. Much FDI never becomes investment in the real sense: mergers and acquisitions (M&As) are mere transfers of ownership of existing assets from domestic to foreign firms. In some countries investments by MNEs could exceed FDI. This is the case of investments financed through borrowings on domestic capital markets. This phenomenon is more widespread in developed than in developing countries. In the latter, borrowing costs on domestic financial markets are normally much higher than on international markets, and this usually discourages domestic borrowings by MNEs.

A crucial question as regards the development impact of FDI is the extent to which it affects investment by domestic firms (I_d). If it has no effect whatsoever, any increase in FDI ought to be reflected in a dollar-for-dollar increase in total investment. If FDI *crowds out* investment by domestic firms, the increase in total investment (I) ought to be *smaller* than the increase in FDI. Finally, if there is *crowding in*, I ought to increase by *more* than the increase in FDI.

The assessment of the effects of FDI on domestic and total investment is far from being a trivial matter. Little can be said on an *a priori* basis. The effects of FDI on investment may well vary from country to country, depending on domestic policy, the kinds of FDI that a country receives, and the strength of domestic enterprises.

It is possible, however, to specify conditions that are favourable to CI. In developing country settings, foreign investments that introduce goods and services that are new to the domestic economy, be they for the export or domestic market, are more likely to have favourable effects on capital formation than foreign investments in areas where there already exist domestic producers. In the former case, the effects on capital formation will be positive because domestic producers do not have the knowledge required to undertake these activities and, therefore, foreign investors do not displace domestic investors.

This is precisely the spirit of Romer's (1993) important paper on the contribution of FDI to development. In Romer's paper, FDI is the driving force for the introduction of new goods to the economy and for the provision of human capital resources that are able to produce such goods.

If FDI enters the economy in sectors where there are competing domestic firms (or firms already producing for export markets), it may well pre-empt investment opportunities that were open to domestic entrepreneurs prior to the foreign investments. In other words, such FDI is likely to reduce domestic investments that would have been undertaken, if not immediately at least in the future, by domestic producers.[i] The contribution to total capital formation of such FDI is likely to be less than the FDI flow itself.

This leads to a hypothesis linking the contribution of FDI to capital formation to the sector of the economy to which it goes. When the distribution of FDI by sector of the economy is substantially different from the distribution of the existing capital stock or of production, the contribution of FDI to capital formation will be more positive than when the distribution of FDI follows roughly the existing distribution of the capital stock by sector. In other words, *the relationship between FDI and domestic investment is likely to be complementary when investment is in an undeveloped sector of the economy* (owing to technological factors or to the lack of knowledge of foreign markets). On the other hand, *FDI is more likely to substitute for domestic investment when it takes place in sectors where there exist plenty of domestic firms*. The same may occur where domestic firms already have access to the technology that the MNE brings to the country.

One can, of course, make an argument for exactly the opposite hypothesis. For instance, MNE investments in new activities may pre-empt investments by domestic firms that, with proper nurturing by government, could be in a position to enter the sector. This was the rationale for limiting foreign investments in certain high technology sectors in South Korea and Taiwan. The bet in these cases was that domestic firms could in fact emerge, and it paid off (see Amsden, 1989; Wade, 1990). In most other cases in the developing world, however, the appearance of domestic producers in a new sector is unlikely or might take too long. Policies to foster entrepreneurship in new sectors can be very costly to the economy as a whole, if these sectors have technological requirements that run too far ahead of domestic capabilities. Besides, there are very few countries where governments can be as effective in nurturing technologically advanced domestic firms as the governments of South Korea or Taiwan were in the heyday of their industrialization drive. Examples of botched and costly intervention in favour of domestic firms in high-technology sectors abound in the developing world. One of the most disastrous was the Brazilian "informatics policy" of the early 1980s, which involved severe restrictions on FDI in information technology sectors. These restrictions led to very little domestic investment, and the firms that were created were highly inefficient. The policy was abandoned well before the programme was due to expire.

Also, it could be argued that the entry of a MNE into a sector where there exist several domestic firms may lead to investments by incumbent domestic firms in order to become more competitive. However, given the vast technological superiority of MNEs, their investments are more likely to displace domestic firms and even cause their bankruptcy than to induce domestic firms to invest.

Even where FDI does not displace domestic investment, foreign investments may not stimulate new downstream or upstream production and, therefore, may fail to exert strong CI effects on domestic investment. *Thus the existence of backward or forward linkages from the establishment of foreign investors is a key consideration for determining the total impact of FDI on capital formation.*

It should be stressed, though, that linkages are a necessary but not sufficient factor for CI. In cases where foreign firms simply displace existing firms, the existence of linkages cannot prevent CO.

One may also hypothesize that the impact on investment is superior when FDI takes the form of a greenfield investment than when it is a M&A. This is ultimately an empirical matter. In studies on the impact of FDI on development in Latin America, sample surveys of MNE affiliates in Argentina and Chile revealed that, for the firms interviewed, the purchase of existing assets was a small component of the total investment. Post-purchase investments very often included modernization and rationalization of operations, and, above all, investments in technology (see Agosin, 1996; Riveros, Vatter, and Agosin, 1996; Chudnovsky, López, and Porta, 1996). These investments were particularly large in the privatizations of telecommunications and public utilities in Argentina in the early 1990s. Most of the acquisitions in Argentina and Chile during this period were made with the intention of running the firms so acquired and bringing them up to date technologically.

But M&As may not lead to any increase in the physical capital of a host country. In some cases, the acquisition of a domestic firm is almost akin to a portfolio investment, with the MNE doing nothing to improve the operation of the domestic company. This was the case of several acquisitions in Latin America in the 1990s, as those economies became desirable destinations of portfolio investments. Very recently, there have been a large number of such cases of FDI, all with doubtful impacts on capital formation. Many of the acquired companies are not in need of modernizing, since they operate with state-of-the-art technology. Nor is it likely that their purchase by a foreign company will be followed up by sequential investment that the acquired firms would not have made themselves. In such cases, FDI is *not* investment in the national accounts sense, and it does not lead to investments later.

In fact, large M&As, like large portfolio inflows, may have adverse macroeconomic externalities on the most interesting types of investments. When they are of a size that can no longer be considered marginal, M&As tend to appreciate the exchange rate and discourage investment for export markets (and, indeed, for the production of importables as well). In small countries, these investments constitute the engine of growth of the economy.

It is interesting that M&As are prohibited or heavily restricted in some of the most successful newly industrialized countries. Up until the late 1990s, Taiwan restricted foreign ownership of the equity of domestic companies in two ways. A single foreign person or entity could own no more than 15 per cent of a domestic company, and all foreigners together were not allowed to own more than 30 per cent in the equity of a domestic company. Until the financial crisis of 1997-1998, the Republic of Korea maintained similar restrictions. In order to assist in the restructuring of industry and to attract FDI, these restrictions have been dropped (Agosin, 2001).

It is often argued that an acquisition will lead to capital formation indirectly, when those who have been bought out invest in new sectors of the economy. But the effect is likely to be weak, if it occurs at all. Most acquired firms are joint stock companies, and the shares purchased through a buy-out are tendered by stockholders who are more likely to use the proceeds to purchase other financial assets (at home or even abroad) than to make real investments. Thus the relationship between acquisitions of domestic firms by MNEs and real investment may be very tenuous indeed.

There are other macroeconomic externalities of MNE activities that could lead to CO. MNEs are not marginal in many, if not most, developing countries. Therefore, their activities have macroeconomic effects. By raising domestic interest rates, the borrowing by MNEs on domestic financial markets may displace investment by domestic firms. Such borrowings may also worsen foreign exchange problems during times of balance-of-payments crisis, as borrowing in domestic currency can be converted to foreign exchange and easily sent abroad by companies operating in global markets and having global financial connections.

To what extent this takes place in actual fact is an empirical question, and undoubtedly the situation will vary from country to country. But it may be critical in small countries negotiating with large firms. For example, in its foreign investment regulations, Chile, which has very liberal policies toward FDI, has retained the right to limit the access of foreign companies to the domestic banking system, if national conditions so warrant. The provision has never been invoked, but its very existence is a reminder that, for a small country, borrowing on domestic markets by MNE affiliates may, under certain circumstances, be problematic.

The empirical evidence on CI or CO

Undoubtedly, a part of FDI will become physical investment. It is very likely that this share will rise with the extent to which FDI is of the greenfield variety rather than M&As. As can be seen in table 2, a significant proportion of FDI takes the form of acquisition of existing assets, which seems to validate the presumption that not all FDI becomes new capital investment. In the developing world, this share is particularly high in Latin America, where a significant share of FDI has gone into sectors that are particularly suited to M&As, such as telecommunications, energy, water and sanitation. In Asia, on the other hand, the share of M&As is low, because the regional FDI totals in recent years are very influenced by the enormous flows going to China, where M&As, by deliberate policy, are practically non-existent.

Table 2

Mergers and acquisitions, as a percentage of FDI (percentage)

Region	2002	2003	2004
Developed countries	58.9	55.3	83.1
Developing countries	17.7	18.7	17.1
Africa	36.1	35.7	25.4
Asia	18.8	21.3	16.8
Latin America	44.4	25.8	37.4
Central and Eastern Europe	22.4	51.4	28.8

Source: UNCTAD (2006).

Moreover, even the part of FDI that is fresh investment may not add much to capital formation, if it crowds out investments that would have been carried out by domestic firms. In a recent paper, Agosin and Machado (2005) performed a series of econometric exercise to determine the extent to which FDI crowded in or out domestic investment in three developing regions (Africa, Asia, and Latin America) over the period 1971-2000, and during each of the three decades of the period. The results suggest that, over the entire period (1971-2000), FDI displaced domestic investment in Latin America. In Africa and Asia, on the other hand, FDI increased overall investment one-to-one. In other words, there was no crowding in or crowding out, and foreign investment added to total investment one-to-one. If the three decades are taken separately, the results show CO in Latin America in the seventies and in Africa in the nineties. So, even in the case where FDI is of the greenfield variety, CI is not assured, because part of that investment could have been undertaken by domestic firms which are pre-empted by multinationals.

Why are multinationals able to pre-empt national firms? Basically because of their superior technology, access to human capital, their ability to penetrate their own domestic markets, or their access to cheap financing. While these advantages are also the main reasons why their presence in host developing countries are sought after assiduously, the authorities of these countries must ask themselves the question of whether domestic firms could have build up some or all of these assets given a reasonable period of time. If the answer is negative, then multinational engagement can be seen in a positive light. However, if the answer is positive, then more selective policies to multinationals do seem in order.

Policy implications

The main conclusion that emerges from this analysis is that positive impacts of FDI on domestic investment are not assured. In some cases, total investment may increase much less than FDI or may even fail to rise when a country experiences an increase in FDI. Therefore, the assumption that underpins policy toward FDI in most developing countries –that a liberal policy toward MNEs is sufficient to ensure positive effects – fails to be upheld by the data. A recent paper (Agosin and Machado, 2007) shows that the most far-reaching liberalizations of FDI regimes in the 1990s took place in Latin America, and that FDI regimes in Asia have remained the least liberal in the developing world.[ii] Several Asian countries still practice screening of investment applications and grant differential incentives to different firms. As already noted, some types of investment have remained prohibited for most of the period under review. In Latin America, on the other hand, these practices have been eliminated in most countries. Nonetheless, liberalization during the nineties appears to have not changed the effects of FDI on investment as compared to the eighties.

In addition, the paper by Agosin and Machado (2007) shows that FDI liberalization, even after controlling for other variables that may affect FDI, does not necessarily result in higher volumes of FDI. Liberalization appears to be a necessary but not a sufficient condition for attracting FDI. The host country's locational advantages seem to be a lot more important. An important aspect of those advantages is clearly the security of property rights. No amount of liberalization will attract FDI in the absence of legal assurance against expropriation or curtailment of investors' rights. In addition, the host country's assets from the point of view of the investing multinationals are also important, such as the availability of natural resources, good quality and low cost labor, large domestic markets, etc.

Of course, FDI may be desirable for other reasons, which are not analyzed here in detail. While raising the investment rate is undoubtedly the most important one, there are other benefits that can be expected of FDI and multinationals in general. For example, the entrance of a multinational can increase competition and force national firms to modernize. Many developing country markets are characterized by various degrees of imperfect competitions. A cozy coexistence of a few large firms may well be the norm. That coexistence can be broken by the entry of a large foreign firm, to the benefit of consumers. If the sector produces an input that is essential to the competitiveness of an upstream user sector, the entry of a multinational may lead to a spurt of growth and higher employment at higher wages.

Multinationals may also bring new technology, and they are courted by host countries precisely for this reason. But this need not always be the case. It is an empirical matter whether multinationals in fact introduce new technologies into host economies. Clearly, a policy toward FDI should keep in mind the technological contribution of multinationals. This will require discriminating between different investments on offer. But not all developing country bureaucracies are able to do so in an effective manner while avoiding being co-opted (or bribed) by the companies they are supposed to screen.

This analysis suggests that, while there is considerable scope for active policies that discriminate in favour of foreign investments that have positive effects on total investment, this is not an easy matter. This does not mean having to decide on each investment project or to practice cumbersome screening of investments, which will only work to discourage potential investors. But it does mean favoring some investments over others. Better to have greenfield investments than purchases of existing assets. Better to have investments that broaden a country's export portfolio than others that come to do more of the same. Better to have investments outside export-processing zones that use domestic inputs than investments inside export-processing zones that have no connection with the domestic economy other than using labor and paying for utilities. This may require complementing an open investment policy with a simple system of incentives for desired activities. And, of course, it also means discouraging the wrong type of investments. One such case in point is the use of income-tax exemptions for firms located in export-processing zones.

Different countries clearly need different policy approaches. Selectivity toward investment, be it national or multinational, has yielded very positive results in some countries, notably the Asian exporters of manufactures. Other, lower-income, countries have fared considerably worse with the same policies. The poorer the country and less developed its human resources, the more it should concentrate on fundamentals: good governance, ensuring that property rights are secure, good macroeconomic policies. Without the human resources and the social compact between business and government that is necessary for active industrial policies, it is better to eschew them. Many countries have attempted active industrial policies, of which FDI policies are an aspect, with disastrous results. Rent seeking and policies that impede firms from taking advantage of existing comparative advantages have, in many cases, led to development disasters.

Does this mean that active policies toward FDI, and also toward domestic investment, are useless? Far from it. A large number of countries have been able to do very well with these policies. Such countries include not only the star performers of Asia but also countries such as Finland and Ireland. These countries have been able to develop new comparative advantages through making winners, not just picking them. They have worked on the large variety of factors that make for success such as coordinating private investment to ensure that all the pieces of the puzzle are there at the time they are needed.

Their use of incentives has been sparing and oriented to getting good value for money. Ireland, for example, gave start up grants to firms in selected sectors, against the promise that they would stay in the country at least for 10 years. The grants paid for themselves in an average of four years in terms of the taxes collected from the firms. Some of the sectors chosen were information and telecommunication technologies, finance, and pharmaceuticals. These firms had large backward and forward linkages and encouraged the emergence of strong clusters with lots of domestic and further foreign investment.[iii]

What the examples of Ireland, East Asia, and Finland teach us is that active policies toward FDI must be framed by country visions, which orient development strategies, which in turn are the framework of policies. Not every country has arrived at the stage where this complex socio-economic-political process is possible to implement. It requires a social compact between business and government. For example, businesses do receive certain incentives, but as a *quid pro quo* they are expected to perform. Also, the government bureaucracy is able to spot where development pay-offs exist. While many countries are not there yet, many are. The crux is for the authorities to determine at what stage they are. Not an easy task.

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[1] Of course, such foreign investments may be desirable for other reasons, such as introducing competition into stagnant or backward sectors. However, what we are concerned about here is the impact on domestic investment and entrepreneurship. Given the enormous superiority of MNEs over domestic firms in most developing countries, the competition is likely to be one-sided.

[ii] Of course, we are dealing with matters of degree. Investment regimes have become pretty liberal throughout the developing world as a consequence of a profound reassessment of the benefits and costs of FDI.

[iii] Of course, it helped that Ireland was a member of the European Union and, as such, had an assured and huge market.