# Part Two

## Foreign Direct Investment and the Challenge of Development

# CHAPTER V

## THE CONTEXT AND ITS CHALLENGE

Economic development remains an urgent global need. Globalization - which links countries closer than ever before with each other (UNCTAD, 1994, chapter III) - reinforces this need. Although many countries have achieved impressive increases in income, over a billion people in more than a hundred countries still live in poverty. Economic inequalities within countries remain large, and there is little sign of convergence in incomes across countries (UNCTAD, 1997b). In fact, a number of developing countries face increasing marginalization.

Globalization accentuates the increasing importance of the international economy for developing countries. Flows of finance, information, skills, technology, goods and services between countries are increasing rapidly. FDI is one of the most dynamic of the increasing international resource flows to developing countries. FDI flows are particularly important because FDI is a package of tangible and intangible assets, and because the firms - TNCs - deploying them are now important players in the global economy. TNCs can affect development, by complementing domestic investment and by undertaking trade and transfers of knowledge, skills and technology. However, TNCs do not substitute for domestic effort: they can only provide access to tangible and intangible assets and catalyse domestic investment and capabilities. In a world of intensifying competition and accelerating technological change, this complementary and catalytic role can be very valuable. Since globalization has its dangers, countries need to prepare their own capabilities to harness its potential, including through FDI. However, FDI on its own cannot counteract the marginalization of developing countries.

Part Two of *WIR99* examines the development impact of FDI in the context of globalization and in the light of the changing circumstances of the global economy. It analyses if and how TNCs assist or hamper developing host countries in achieving their development objectives, and outlines options for domestic and international policies to enhance the positive and mitigate the negative aspects of the impact of TNCs. In dealing with development, *WIR* uses the United Nations definition of "sustainable human development", a definition that encompasses economic, social, political, environmental and other dimensions (box V.1). While it focuses on economic development - where FDI can make the most difference - it also considers the social and environmental effects of TNCs.

**Box V.1. Evolution of approaches to development**

A comprehensive view of development is at least as old as the United Nations Charter of 1944. The Charter mentioned development in the context of economic and social progress and higher standards of living as well as cultural, educational and health matters.

But another approach, centred on economic growth, has predominated much of the thinking and practice related to development since the early years of development cooperation. It focused on resources for investment (initially coupled with the requirements of reconstruction in war-devastated economies) to increase production or incomes and, thereby, consumption levels, and on the provision of basic goods and services. This approach remained influential in development co-operation until the late 1980s. The discussion on development in the United Nations continued, becoming occasionally a subject of East-West ideological disputes, but nonetheless contributing to a better understanding of the complex nature of development. For example, during the 1960s, the useful concept of basic needs was introduced (Gasper, 1996).

With the end of the East-West divide in the early 1990s, the discussion was freed from political power play. Over the past decade, the notion of development has evolved into one that emphasizes sustainable and human development. Environmental soundness, social justice, political freedom, gender equality and, most recently, social inclusion have become integral development considerations. The Programme of Action of the 1995 World Summit for Social Development, for example, embraces a concept of development that includes both developed and developing countries, and deals with eradicating absolute poverty, expanding employment, and enhancing social integration (UNRISD, 1995).

These development objectives are also found in the preambles of development strategies, development plans and other types of policy statements of developing countries, and in selected international policy instruments. Governments stress in their policy statements a broad concept of development. For instance, the ninth Five Year Plan of India, entitled *Growth with Social Justice and Equity*, states as its objectives improved quality of life, generation of productive employment, regional balance and self-reliance (India, Government of India, 1997). In the same tradition, most regional, plurilateral and multilateral trade (and investment) agreements use a notion of development that encompasses growth, efficiency, employment and social justice (UNCTAD, 1996a).

A broad consensus is now emerging that development and development co-operation focusing only on economic growth are not sufficient. It is also important to advance the social and institutional aspects of development (World Bank, 1999a; Stiglitz, 1998b). The Agenda for Development, debated by the General Assembly for four years, pulled together the development aspirations voiced at the major United Nations conferences of the 1990s, to arrive at the concept of sustainable development (United Nations, 1997).

It has become increasingly recognized that there are many different paths to development and that there is no single, fixed definition of "development". The goals of development vary, and there are many ways of reaching those goals (Sachs, 1992). Development is increasingly seen as an open-ended process and indeed, defined very loosely as a "broadening of people's choice's" (UNDP, 1998).

In spite of these differences, however, one thing is clear: development is much more than economic growth and economic development. It encompasses social and other aspects of human advancement although there may be differences of opinion on the precise contents and direction of the latter. In retrospect, the United Nations Charter of 1944 has proven to be quite a visionary document.

*Source*: UNCTAD.

## A. The changing context of development

The factors that propel sustained economic development have not changed over time. They include the generation and efficient allocation of capital and labour, the application of technology and the creation of skills and institutions. These factors determine how well each economy uses its endowments and adds to them. They also affect how flexibly and dynamically each country responds to changing economic conditions. However, the global context for development has changed enormously over the past three decades. These changes affect not only the role of FDI in host countries, but also government policies on FDI. The following three are of particular significance.

- ***The nature and pace of knowledge - and, particularly, technological knowledge - change***. The creation and diffusion of productive knowledge have become central to growth and development (Mytelka, 1987; Dunning, 1997; World Bank, 1998). "Knowledge" includes not only *technical* knowledge (research and development, design, process engineering), but also knowledge of organization, management and inter-firm and international relationships. Much of this knowledge is tacit. Today, the resources devoted to such knowledge exceed investment in tangible machinery and equipment in many of the world's most dynamic firms, and the costs of generating new knowledge are rising constantly. The importance of knowledge is not limited to modern or high-tech activities but pervades all sectors and industries, including traditional activities in the primary sector (for instance, vegetable and flower exports), manufacturing (such as textiles, clothing and footwear), and services (such as tourism and banking). As a result, achieving development objectives is, more than ever, a continuous learning process.

  The sheer pace of technological change, in particular, is unprecedented and is accelerating. This means that enterprises that want to be competitive internationally need both the knowledge to use technologies efficiently and to keep pace with developments. Innovators need to invest more in creating new knowledge, but even followers need the capacity - difficult to acquire - to access and use this new knowledge, or in fortuitous circumstances, to identify windows of opportunity for technological leaps. The skills required for this are changing concomitantly, as are institutions and their relations with productive enterprises; one development is the closer linking of science with technology-generation in industry. An important result of this new "technological paradigm" (Freeman and Perez, 1988) is that research-intensive activities are growing more rapidly than others in production and trade; thus, sustained economic growth calls increasingly not just for the application of new technology to existing activities, but also for a shift of activities up the value-added chain.

  The most profound technological changes today emanate from a merger of communications and information processing technologies (World Bank, 1998). While the telegraph, telephone and computer were significant technological achievements, they pale in comparison with emerging technologies based on the interface between microprocessors and telecommunications. These are generic technologies that affect practically the whole range of economic and even social and cultural activities. Information can now be transmitted across the globe at very low cost. For example the cost of sending a million bits one kilometer via optical fibre today is less than 10 per cent of what it was in 1975 (World Bank, 1998). The processing of information and trade in information-intensive services is one of the most important occupations in today's knowledge-intensive economy.

- ***Shrinking economic space and changing competitive conditions***. Technical progress in transport and communications has caused economic space to shrink dramatically. Countries now face much more intense and immediate competition than ever before. This leads to a significant restructuring of their comparative advantages and activities. The nature of competition itself is changing, with the rapid introduction of new products, shorter product cycles, flexibility of response to demand, and customer interaction becoming more important than traditional forms of competition based on lower costs (Best, 1990). At the enterprise level, this calls for new management and technical skills and organizational forms. In many instances, it leads to flatter hierarchies and greater use of networking and cooperation between related firms and also competing firms (for instance, component suppliers now play a much more direct role in new technology development). At the national level, it requires countries to be more open to international flows of information, and to improve national capabilities to absorb and use that information: to develop new skills, institutions and innovative capacities. Countries that can do that - either generally or in niche markets - can move up the value-added ladder.

- ***Changing attitudes and policy regimes***. Most developing and transition countries have moved to market-oriented and private sector led economies. This shift reflects

disillusionment with past strategies and growing difficulties in pursuing them in the new technological and competitive setting. The shrinking of economic space has itself rendered elements of traditional strategies obsolete, while the flow of information has made governments more aware of policies and performance in other countries. Policy benchmarking in all areas is becoming more common which, in turn, puts more pressure on countries to innovate in the policy arena. There is widespread reduction and removal of trade barriers, deregulation of internal markets, privatization and liberalization of technology and investment flows at the national level. At the international level, regulation has intensified and is being harmonized. For instance, the TRIPS agreement of the Uruguay Round has introduced a common, more rigorous, system of intellectual property protection; the TRIMs agreement has established disciplines over certain performance requirements; and quality requirements such as ISO standards are becoming prerequisites for participating in international production and trade. Thus, in a sense, some regulation is shifting to the international plane.

Perhaps nowhere is the policy change more striking than in the changing attitude of governments to TNCs (box V.2). Twenty years ago or so, many governments saw TNCs as part of the "development problem". Today, TNCs are seen as part of the "solution". Indeed, if anything, expectations are sometimes too high, as FDI plays in most instances only a complementary and at best a catalytic role. Reflecting this change of attitude, FDI is now not just permitted - it is avidly sought by governments and, indeed, many sub-national public sector entities at all levels, from provinces to individual communities. Apart from active promotion (which has led to the establishment of investment promotion agencies in a great number of countries, having at their disposal an array of incentives), policy liberalization is the principal tool.

In particular, entry and operational conditions have been liberalized and standards of treatment of foreign affiliates have been strengthened. Liberalization has been extended to such service industries as telecommunication, transportation and power generation and distribution, previously closed to foreign investors. Many developing countries and economies in transition have concluded bilateral treaties to protect FDI and avoid double taxation. A number of regional schemes (notably the European Union, NAFTA, ASEAN and MERCOSUR) have reduced barriers to FDI or are in the process of doing so, facilitating intra-regional investment and trade flows. At the multilateral level, the General Agreement on Trade in Services has contributed to the liberalization of FDI in services, and the TRIMs Agreement has restricted the use of certain performance requirements. The FDI global regime that has emerged after these changes, though uneven, is much more friendly towards foreign investors than in the past.

**Box V.2. Why have governments changed their attitudes to TNCs?**

There are several reasons for the change in attitudes towards TNCs and the intensification of competition for FDI. Governments recognize that TNCs can provide a package of external resources that can contribute to development. There is also now an increasing number of TNCs from developing countries, reflected in the fact that the share of developing countries in FDI outflows has increased from about two per cent at the beginning of the 1980s to approximately 15 per cent of a much higher total in the mid-1990s (figure I.12); their home governments want access for their firms to foreign markets and locations. At the same time, many governments have improved their administrative capabilities and feel more comfortable in dealing with TNCs. Efficient FDI screening has been "difficult even for countries with sophisticated bureaucracies, given the need to relate it to changing country and sectoral advantages, changing firm strategies and competition, and political pressures from other countries" (Safarian, forthcoming). On the aggregate level, external financing has shifted from official to private sources, especially towards FDI (box figure I.1). Finally, the liberalization of FDI (and trade) policy is often part of the conditionality in IMF and World Bank adjustment programmes, and is promoted by many leading aid donors.

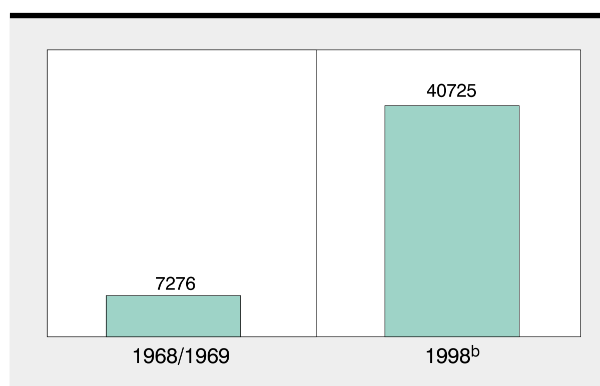
*Source*: UNCTAD.

## B. The changing context for TNCs

Knowledge-intensive production, technological change, shrinking economic space and greater openness have also changed the context for TNCs. There are new opportunities - and pressures - to utilize them. The opening of markets creates new geographical space for TNCs to expand in and access tangible and intangible resources. It also permits wider choice in the methods firms can use (FDI, trade, licensing, subcontracting, franchising, partnering and so on) to operate in different locations. At the same time, advances in information, communication and transportation technologies, as well as in managerial and organizational methods, facilitate the transnationalization of many firms, including SMEs. The combination of better access to resources and a better ability to organize production transnationally increases the pressure on firms to utilize new opportunities, lest their competitors do so first and gain a competitive advantage. Competition is everywhere - there are fewer and fewer profit reservations and market niches that remain protected from the fierce winds of competition. Indeed, a portfolio of locational assets - allowing firms to combine their mobile advantages most effectively with the immobile tangible and intangible resources of specific locations - is becoming an increasingly important source of corporate competitiveness (UNCTAD, 1995a).

Firms have reacted accordingly. A highly visible group of large "traditional" TNCs continues to grow (see figure III.1), often with turnovers larger than the national incomes of many developing countries. There are also many new entrants, such as large firms from developed countries that had confined themselves previously to domestic operations (e.g., telecommunications operators). Many are smaller firms from these countries that find it necessary to invest overseas to exploit their ownership advantages or to seek new advantages and alliances. An increasing number are firms from developing countries, both small and large (see table I.1). And some are large and small firms from economies in transition, countries that previously had isolated themselves largely from international investment (see table III.13). As a result, the number of TNCs has increased substantially, having reached at least 60,000 at the end of the 1990s (table I.1). Between the end of the 1960s and the end of the 1990s, the number of TNCs in 15 of the most important developed home countries had increased from 7,000 to 40,000 (figure V.I). FDI inflows mirror this expansion: from a level of $56 billion worldwide at the beginning of the 1980s, they reached $166 billion to developing countries alone, and $644 billion worldwide, in 1998. Their growth rate was faster than that of both trade and domestic production (table I.2).

**Figure V.1. Number of parent TNCs in selected major home developed countries,[a] 1968/1969 and 1998[b]**




*Source*: UNCTAD, based on United Nations, 1973 and table I.1.

a Fifteen countries namely: Austria, Belgium, Denmark, France, Germany, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

b 1993 for Netherlands: 1995 for Italy and Switzerland: 1996 for Austria, France, Germany and the United States: 1997 for Belgium, Norway, Portugal and the United Kingdom. Luxembourg is not included.

The changing context and the quest for a portfolio of locational assets has also brought about a change in corporate strategies. The following developments are particularly noteworthy:

- A shift from stand-alone, relatively independent, foreign affiliates to integrated international production systems relying on specialized affiliates to service the entire TNC system (UNCTAD, 1993a). Within the framework of this international intra-firm division of labour, any part of the value-added chain of an enterprise can be located abroad while remaining fully integrated into a corporate network. Corporate strategies of this kind

seek to exploit regional or global economies of scale and a higher degree of functional specialization.

- This shift broadens the range of resources sought by TNCs in host countries, making firms more selective in their choices. However, it can also encourage FDI in countries that cannot provide a wide range of resources but have some specific assets that are sought by TNCs (e.g. accounting or software skills).
- A shift towards greater use of non-equity and cooperative relationships with other enterprises, such as alliances, partnerships, management contracts or subcontracting arrangements. These arrangements serve a variety of corporate objectives. They can provide better access to technologies or other assets allowing firms to share the cost and risk of innovatory activities. They can reduce the production cost of labour-intensive products.
- Emergence of a network type of organization. This expands the scope of interactions between TNCs and enterprises from host countries, and also the forms of these interactions.

These changing corporate strategies bring with them a different pattern of international economic integration. Originally, this involved the integration of markets through arm's length trade – "shallow" integration. Integrated international production moves this integration to the level of production in all its aspects – "deep" integration (UNCTAD, 1993a). In the process, a significant part of international transactions becomes internalized, i.e. takes the form of transactions between various parts of transnational corporate systems located in different countries. It is estimated that more than one-third of world trade and some four-fifths of technology flows are internalized within TNCs. The share of world production under the common governance of TNCs is estimated at about one-quarter.

The ability of firms to allocate their economic assets internationally, and the international production system created in the process, have become themselves a part of the new context. As a result, TNCs have indeed become important actors in the world economy and, hence, the development process - a fact reflected in the competition of all countries for FDI. Indeed, increasingly, the decision where to locate production facilities of any kind becomes crucial for development, because the decision where to locate becomes a decision where to invest and from where to trade. And it becomes an FDI decision if the location chosen is abroad (UNCTAD, 1996a).

## C. The challenge

This, then, is the panorama at the end of this century, and the challenge that it entails for the next.

More large and small firms, from more countries, in virtually all industries are investing abroad, be it through the expansion of existing facilities, greenfield projects, M&As, the acquisition of assets in the framework of privatization programmes or through various forms of non-equity relationships. All countries, and increasingly their provinces and individual municipalities, seek to attract FDI. The world market for FDI is global, and it is characterized - and driven - by competition: competition between firms and competition between countries. Perhaps as many as 6,000 national, regional and local public sector entities compete each year for the various investment projects undertaken each year by TNCs.

The policy challenge for countries - and especially developing countries and economies in transition - is two-fold:

- To guard themselves, in their eagerness to attract FDI, against engaging a financial incentives-competition race towards the sky; a fiscal incentives-competition race towards zero; or a policy-competition race towards the bottom. There are many indications that such races are under way (UNCTAD, 1996a, d). "Incentive wars" take place both between countries and within countries.
- To pursue policies, and implement policy measures, that help countries *attract* FDI and

especially to *benefit* from it as much as possible - in short, to maximize the contribution that FDI can make to development.

As the first of these challenges has been partially addressed elsewhere (UNCTAD, 1996a, d), the focus of *WIR99* is on the second challenge.

In the ideal scenario, countries have something to offer that TNCs need to increase their profitability and competitiveness: a portfolio of locational assets that includes access to markets and immobile tangible and intangible resources. Similarly, firms can offer things that countries need to advance their development: a package of mobile tangible and intangible assets that includes capital, technology, know-how, skills, brand names, organizational and managerial practices, access to markets, competitive pressures, and environmentally sound technologies and managerial practices. FDI statistics capture these assets only very imperfectly (see chapter I). But developments over the past decade and a half suggest that the global supply of FDI is quite elastic, and its limits are unclear. FDI world-wide represented only eight per cent of gross domestic capital formation (10 per cent for the developing countries as a group) in 1997. It is quite possible that FDI could reach substantially higher levels and proportions. This does not mean, however, that FDI flows will be evenly distributed across countries or regions, or reflect their relative needs - another reason why the emphasis of policy makers needs to remain on domestic enterprise development.

However, it needs to be recognized that the basic objectives of TNCs and governments are not the same: governments seek to spur *development* - within a *national* context. TNCs seek to enhance their *competitiveness* in an *international* context. Not all FDI is, therefore, always and automatically in the best interest of host countries. Some can have an adverse effect on development. TNCs seek to enhance their own competitiveness, not to develop host economies. Their needs and strategies may differ from the needs and objectives of host countries. The presence of TNCs in a host country may conflict with building strong national firms. Or, a host country may seek new technologies while a foreign affiliate may wish to use mature technologies. Or again, a TNC may find it efficient to close an affiliate in the face of import liberalization or shifting comparative advantage while a host country wants to preserve employment. TNCs may seek stronger protection for intellectual property rights, while a host country may favour weak intellectual property rights to permit greater diffusion of technology. There are many situations in which strategies and needs can differ between TNCs and host countries - and, one may add, between TNCs and home countries, be they developed or developing.

Still, there is a considerable overlap between the objectives of host countries and TNCs. Indeed, to a large extent an investment (including FDI)-friendly policy framework is also a development-friendly policy framework. Since the overlap is incomplete, it is to the advantage of governments not only to try to attract FDI, but also to try to maximize its net contribution to development. Policies matter - perhaps more than ever. TNCs, like other firms, respond to government policies. However, they are better equipped than national firms to escape the constraints of policies that they find inconvenient. They can move their activities abroad more easily, or use internal channels (e.g. transfer pricing) not open to national firms. On the other hand, they can also respond to policy signals in a differentiated manner: a TNC can simultaneously have import-substituting and export-oriented facilities in different host countries. Under certain conditions, they may contribute more than national firms because of their greater access to a whole range of resources. For instance, when an economy opens up to trade, TNCs can restructure their affiliates to reach international levels of technology and productivity.

FDI policies have also changed. In the past, governments of developing countries used ownership rules, operational restrictions, performance requirements and the like to influence TNCs in desired directions. These tools are increasingly difficult (if not impossible) to use in the new investment and trade policy frameworks. Governments now focus more on improving the broader setting in which TNCs operate - macroeconomic management, infrastructure provision, human capital, competition policy, and the like. In short, they seek to entice TNCs to do what they would like to see done, as opposed unilaterally to seeking to impose their objectives on them. The line between “imposing” and “enticing” is a fine one and impossible to draw in a general manner. More often than not, it is a matter of the right policy mix of carrot and stick,

reflecting, of course, the specific attributes and objectives of countries and companies.

Most importantly, good FDI policies must recognize that FDI can complement domestic efforts to meet development objectives. For this to happen, FDI policies cannot be pursued in isolation. Instead, they must be inextricably linked with policies in core areas of economic development, aimed at:

- increasing domestic financial resources for development, to supplement domestic savings and investment and, more basically, fostering enterprise development, as the creation of an efficient domestic supply capacity requires competitive economic agents;
- enhancing the technology, skill and knowledge base, given that these intangible resources are increasingly at the heart of the development effort;
- boosting trade competitiveness, as internationally competitive firms can contribute better to development by reaping the benefits of economies of specialization and scale, by broadening the demand base;
- maintaining competitive markets, to ensure that former statutory obstacles to investment and trade are not replaced by anticompetitive practices of firms; and
- protecting the natural environment, to maintain the basis for future growth and development.

This Part of *WIR99* focuses on the extent to which FDI can make a contribution in each of these core areas of economic development and how this contribution can be enhanced: investible financial resources (chapter VI); technological capabilities (VII); trade competitiveness (VIII); employment and the skill base (IX); and the environment (X). These issues are analysed separately, for analytical purposes only. They are then drawn together in a chapter (XI) which makes an overall assessment of the impact of FDI on economic development and discusses in an integrated manner policies to maximize the positive, and minimize the negative, aspects of this impact. A chapter addressing the social responsibilities of TNCs concludes this Part.

The following five chapters have a common structure:

- a brief discussion of the role of each area in development and salient changes that have altered the context for development and FDI;
- a brief review of the role of TNCs in the area, how it has changed and how their strategies may matter for the role of that area for development;
- a conceptual and empirical analysis of the impact of FDI on host developing countries and how this impact differs from that of national firms;
- policy measures for enhancing the positive and minimizing the negative impacts of FDI on development.

In addition, each chapter addresses, where relevant, some cross-cutting issues. These include effects on developing countries at different levels of development and especially the concerns of developing countries in each area.

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The world in which governments and TNCs operate is in a state of considerable flux. There is much greater interest in FDI issues than before - and not only on the part of governments at all levels, but also on the part of a range of civil society stakeholders. Non-governmental organizations in particular have entered the political and economic scene as actors with strong concerns - and means of voicing them - about various aspects of TNC strategy and impact. It is therefore vital to understand the nature of the role of TNCs in development, in the interest of an informed debate and proper policy making at sub-national, national, regional and multilateral levels.

## Note

1 Data provided by *Corporate Location* magazine.