

OVERVIEW

The momentum for the expansion of international production continues to hold, though the world economy is currently affected by a number of factors that could discourage investment, including FDI by TNCs. FDI flows to developing countries declined in 1998, but that decline was confined to a few countries. Technology flows, as measured by technology payments, continued to grow, partly reflecting the increasing importance of technology in the production process. Cross-border M&As among developed countries have driven the expansion of FDI flows and international production capacity in 1998. This suggests that, in the face of diminished financing and reduced market prospects world-wide, TNCs in the Triad are concentrating on consolidating their assets and activities so as to strengthen their readiness for global expansion or survival once the health of the world economy, including countries affected by the recent financial crises and their aftermath, is fully restored.

TRENDS

Transnational corporations drive international production ...

International production – the production of goods and services in countries that is controlled and managed by firms headquartered in other countries – is at the core of the process of globalization. Transnational corporations (TNCs) – the firms that engage in international production – now comprise over 500,000 foreign affiliates established by some 60,000 parent companies, many of which also have non-equity relationships with a large number of independent firms. The TNC universe comprises large firms mainly from developed countries, but also firms from developing countries and, more recently, firms from economies in transition, as well as small- and medium-sized firms. A small number of TNCs, ranking at the top, are noteworthy for their role and relative importance in international production:

- The world's 100 largest non-financial TNCs together held \$1.8 trillion in foreign assets, sold products worth \$2.1 trillion abroad and employed some six million persons in their foreign affiliates in 1997. They accounted for an estimated 15 per cent of the foreign assets of all TNCs and 22 per cent of their sales. General Electric is the largest among these TNCs ranked by foreign assets, holding the top place for the second consecutive year. Close to 90 per cent of the top 100 TNCs are from Triad countries (European Union, Japan and United States), while only two developing-country firms - Petroleos de Venezuela and Daewoo - figure in the list. While company rankings may change from year to year, membership in the list of the 100 largest TNCs has not changed much since 1990: about three-quarters of the TNCs in the list in 1997 were already part of the world's 100 largest TNCs in 1990. Even the ranking of the top TNCs by their degree of transnationality (an index reflecting the combined importance of foreign assets, sales and employment as shares of their respective totals) has been fairly stable. Automotive, electronics/electrical

equipment, petroleum and chemicals/ pharmaceuticals are the dominant industries to which firms in the top 100 belong.

- The top 50 non-financial TNCs based in developing countries together held \$105 billion in foreign assets in 1997. The top companies from developing countries are less transnationalized than the world's 100 largest TNCs. They are domiciled in a handful of economies: Hong Kong (China), Republic of Korea, China, Venezuela, Mexico and Brazil. Their industrial composition is different from that of the world's top 100 TNCs, with food and beverages, petroleum, construction and diversified activities being the most important industries.
- The list of the 25 largest TNCs based in Central Europe (not including the Russian Federation) - published for the first time in this year's *World Investment Report* — identifies a new nascent group of investors which, together, held \$2.3 billion in assets abroad in 1998 and had foreign sales worth \$3.7 billion. Employment in their foreign affiliates, however, is low, a factor that reduces the value of the transnationality index for these firms. Most of the top TNCs from Central Europe are active in transportation, chemicals and pharmaceuticals, and natural resources.

The largest TNCs as described above are determined on the basis of the value of assets that they control abroad. Control of assets is usually achieved by a minimum share in equity or ownership, which defines foreign direct investment (FDI). Increasingly, however, TNCs are also operating internationally through non-equity arrangements, including strategic partnerships. A rising number of technology partnerships have been formed, in particular in the information technology, pharmaceutical and automobile industries in the 1990s. Such partnerships assist firms in their search for ways to reduce costs and risks, and provide them with the flexibility required in an uncertain and constantly changing technological environment. Knowledge-based networks, a dimension not captured by the traditional measures of international production, can be a crucial factor of market power in some industries.

... which takes place in an increasingly liberal policy framework.

The trend towards the liberalization of regulatory regimes for foreign direct investment (FDI) continued in 1998, often complemented with proactive promotional measures. Out of 145 regulatory changes relating to FDI made during that year by 60 countries, 94 per cent were in the direction of creating more favourable conditions for FDI. The number of bilateral investment agreements also increased further, reaching a total of 1,726 by the end of 1998, of which 434 had been concluded between developing countries. Close to 40 per cent of the 170 treaties signed that year were between developing countries. By the end of 1998, the number of treaties for the avoidance of double taxation had reached a total of 1,871.

At the regional and interregional levels, rule-making activity on FDI continued to be intense in all regions, mainly in connection with the creation or expansion of regional integration schemes, and typically involving rules for the liberalization and protection of FDI. The most important development in 1998 was that the negotiations on a Multilateral Agreement on Investment within the OECD were discontinued; however, work in the OECD continued in several other investment-related areas. Overall, the question of governance in international business transactions has been a recurrent subject in discussions and work related to international instruments in recent years.

International production has many dimensions ...

International production involves a package of tangible and intangible assets. Its principal global features (which, of course, differ from country to country) can be captured in various ways:

- On the production side, the value of the output under the common governance of TNCs (parent firms and foreign affiliates) amounts to about 25 per cent of global output, one

third of it in host countries. Foreign affiliate sales (of goods and services) in domestic and international markets were about \$11 trillion in 1998, compared to almost \$7 trillion of world exports in the same year. International production is thus more important than international trade in delivering goods and services to foreign markets. In the past decade, both global output and global sales of foreign affiliates have grown faster than world gross domestic product as well as world exports. Judging from data on FDI stock, most international production in developed countries is in services, and most international production in developing countries is in manufacturing. For both groups of countries, FDI in the primary sector has declined, while FDI in services in developing countries is gaining in importance. These shifts reflect changes in the structure of the world economy, as well as changing competitive advantages of firms and locational advantages of countries, and the responses of TNCs to globalization and liberalization.

- Technology flows play an important role in international production. Technology embodied in capital goods exported to foreign affiliates is measured by the value of those exports. Technology provided via contractual agreements is measured by the value of payments and receipts associated with them. And technology transmitted through training is measured by the cost of resources used in the training. Technology payments and receipts of countries in the form of royalty payments and licence fees have risen steadily since the mid-1980s, and the intra-firm (between parent firm and foreign affiliate) share of these expenditures, already high, has also risen. These changes reflect the fact that FDI is increasingly geared to technologically-intensive activities and that technological assets are becoming more and more important for TNCs to maintain and enhance their competitiveness. Much of the increase has taken place in developed countries where royalty payments and receipts have risen faster than FDI flows. These countries accounted for 88 per cent of payments and 98 per cent of receipts of cross-border flows of royalties and licence fees world-wide in 1997.
- Innovation and research and development (R&D) are at the heart of the ownership advantages that propel firms to engage in international production. On the basis of data for Japanese and United States TNCs, it seems that the bulk of R&D expenditure is undertaken by parent firms in their home countries and, when located abroad, mostly in developed countries. Affiliates tend to spend much less on R&D, especially in comparison to the R&D expenditures of the host countries in which they are located, notable exceptions being Ireland and Singapore.
- International trade is stimulated by international production because of the trading activities of TNCs. At the same time, international production takes place because trade is not possible in some cases, such as in the case of certain services that are location-bound because of the need for proximity between buyers and sellers. Trade within TNCs and arm's-length trade associated with TNCs are estimated to account, together, for about two-thirds of world trade, and intra-firm trade, alone, for one-third. High propensities to export on the part of foreign affiliates may be accompanied by high propensities to import, which can lead to trade deficits.
- International production generates employment opportunities that are particularly welcome in host countries with high rates of unemployment. In recent years, employment in foreign affiliates has been rising despite stagnating employment growth in TNC systems as a whole, i.e. when parent firms are also taken into account. The trend towards increasing employment is more pronounced for foreign affiliates in developing countries. However, employment in foreign affiliates is typically a small share of total paid employment in these countries, amounting to not more than two per cent of the workforce. In the manufacturing sector, which receives the bulk of FDI, this share is higher.
- Financial flows associated with international production consist of funds for financing the establishment, acquisition or expansion of foreign affiliates. The source of these funds can be the TNC itself – new equity from parent firms, loans, and/or earnings of foreign affiliates that are reinvested, together defined as FDI. There are also sources of funds

external to a TNC, raised by foreign affiliates in host countries and international capital markets. The expenditure of TNCs on establishing, acquiring or expanding international production facilities is therefore higher in value than the amount normally captured by FDI flows.

- The capital base of international production, regardless of how it is financed, is reflected in the value of assets of foreign affiliates. This is about four times the value of the FDI stock in the case of developed countries, but only marginally higher than the value of the FDI stock in the case of developing countries.

The extent to which a particular host country is involved in international production can be measured by an index of transnationality. It captures the average of the following four ratios: FDI inflows as a percentage of gross fixed capital formation for the past three years; inward FDI stock as a percentage of GDP; value added of foreign affiliates as a percentage of GDP; and employment of foreign affiliates as a percentage of total employment. Among developed countries, New Zealand has the highest transnationality index and Japan, the lowest. Among developing countries, Trinidad and Tobago has the highest index and the Republic of Korea, the lowest. Small host countries tend to score high in terms of the transnationality index.

... that manifest themselves differently in different regions.

With the exception of data on FDI (one source of finance for international production), comprehensive data on the global dimensions of international production are not available. Judging from the growth in FDI inflows and outflows as well as in other variables related to the activities of foreign affiliates, however, more and more firms engage increasingly in international production. In 1998, despite adverse economic conditions such as the financial crisis and ensuing recession in several Asian countries, the financial and economic crisis in the Russian Federation and the repercussions of these crises in some Latin American countries, declining world growth, trade, and commodity prices, and reduced bank lending, portfolio investment and privatization activity, FDI inflows increased by 39 per cent globally, the highest rate since 1987. In 1998, FDI inflows reached \$644 billion, and are projected to increase in 1999 as well. Mergers and acquisitions (M&As) have fuelled the increases in FDI, with a rise of more than \$202 billion in the value of M&As transacted in 1998 as compared with that in 1997. The importance of M&As as modes of expansion of international production implies that the net addition to total physical production capabilities annually is less than that implied by the value of annual FDI flows, since most of the additions may well be created by simply a change in ownership.

The record level reached by world FDI flows in 1998 despite the prevailing gloomy economic environment also masks a high concentration of FDI: the largest 10 home countries accounted for four-fifths of global FDI outflows. It also masks divergent trends for developed and developing countries. In the former, economic growth remained stable, largely unaffected by the recession in Japan or the financial crisis. FDI inflows to and outflows from developed countries soared to new heights – to about \$460 billion and \$595 billion, respectively, in 1998. Economic growth rates in developing countries in Asia plummeted due to the financial crisis and recession, but FDI flows there declined only moderately, cushioned by the impact of currency depreciation, policy liberalization and a more accommodating attitude towards M&As. Nevertheless, largely because of reduced inflows into a few Asian economies, FDI flows to developing countries as a group declined from \$173 billion to \$166 billion. Moreover, the FDI gap among developing countries widened further, with the top five countries receiving 55 per cent of all the developing-country inflows in 1998 and the 48 least developed countries receiving less than one per cent.

Most FDI is located in the developed world, although the developing countries' share had been growing steadily until 1997, when it reached 37 per cent. The subsequent decline (to 28 per cent) in that share in 1998 reflects the strong FDI performance of developed countries in that year. Among developed countries, most FDI is located – and originates – in the Triad, which accounted for almost two-thirds of the outward stock of developed countries in 1997.

Differences in the size as measured by gross domestic product of host economies are an important factor accounting for the differences observed in the shares of various regions and countries in world FDI flows. However, developing countries as a group receive more FDI per dollar of gross domestic product than do developed countries. Furthermore, if differences in economies' size are taken into account, the FDI gap among groups of developing regions diminishes. This is not surprising since FDI is attracted to developing countries also by factors (such as natural resources) not directly related to the size of their economies; it also suggests that the significance of a given amount of FDI for a country depends upon the country's income level. However, even when differences in gross domestic product are controlled for, developed countries remain more important as regards FDI outflows, although the gap between them and developing countries diminishes. Moreover, on a *per capita* basis developing countries receive (and invest abroad) less FDI than do developed countries, reflecting the concentration of population in the former and the concentration of FDI in the latter.

FDI flows from developing countries accounted for 14 per cent of global outflows in 1997, but only eight per cent in 1998. Despite the sharp dip in 1998, the overall trend remains positive: more and more TNCs from developing countries are becoming competitive internationally and possess ownership advantages that allow them to invest abroad, mainly in other developing countries. However, only a handful of developing countries account for the bulk of developing country FDI outflows. Most intra-developing country FDI activity is recorded in East and South-East Asia, especially among ASEAN countries, and recently in Latin America, especially among MERCOSUR members. There are signs that FDI flows from East and South-East Asia to Latin America and Africa are picking up. One way to assist South-South FDI flows is to help firms from developing countries to obtain insurance from MIGA for their investments abroad. As such insurance often depends on the preparation of environmental assessment studies (which, for many firms, especially smaller ones, are quite expensive), the establishment of a trust fund that would provide assistance in this respect should be considered.

Driven by M&As, FDI flows to developed countries register an impressive increase ...

Record FDI inflows into, and outflows from, developed countries are behind the 1998 surge in global FDI. Developed countries accounted for 92 per cent of global outflows and 72 per cent of global inflows in 1997. The developed country picture is characterized by an intensification of TNC-led links between the United States and the European Union, each of them being the largest source of FDI for the other, and by the emergence of Australia, Canada and Switzerland as significant FDI recipients. The cornerstone of the 1998 surge of FDI was, however, the marked growth of FDI flows into the United States and a few European countries, reflecting their solid economic fundamentals.

Most new FDI in 1998, especially between the United States and the European Union, was in the form of M&As. In fact, cross-border M&As drove the large increases in both inflows and outflows for the United States and the strong FDI performance of the developed world as a whole. A new phenomenon is the growth of cross-border M&As in Japan. For developed countries, the value of cross-border M&A sales reached a record \$468 billion in 1998.

The European Union was the largest source of FDI, registering \$386 billion in outflows in 1998. The United Kingdom, with about \$114 billion, was the lead European Union investor. In contrast to the boost to intra- and extra-European Union investment in the late 1980s and early 1990s that resulted from anticipation of the Single Market Programme, steps towards monetary integration manifested by the adoption of a single currency have so far had only little effect on FDI. Flows to members of the European Monetary Union (EMU) increased only slightly more than those to non-members in 1998, and the share of EMU members in total FDI inflows to the EU was still lower than in 1996. This could change in 1999 and beyond, as, with the implementation of the monetary union, its advantages and disadvantages for the location of FDI are understood better.

Japan's outflows declined from \$26 billion in 1997 to \$24 billion in 1998, while inflows remained at almost the same level as in 1997, i.e. \$3.2 billion. Economic recession at home and in neighbouring Asia (translating into fewer sales and lower profits) has reduced both the motivation and the ability of Japanese TNCs to invest abroad. This was manifested by lower outflows of new equity and reinvested profits. Japanese TNCs were hard hit in Asia, suffering losses and having to shift to export-oriented production to the extent possible. To alleviate their difficulties, Japanese TNCs are restructuring their overseas operations. On the other hand, despite the recession in Japan, investment opportunities in Japan, particularly for M&As, are leading to an increase in inflows. Although lower FDI outflows and higher FDI inflows are reducing the gap between FDI inflows to and outflows from Japan, the low level of the former may affect Japan's trade structure.

As this brief review shows, cross-border M&As were the driving force of increased FDI flows in 1998. There are many factors that explain the current wave of M&A – a wave that does not seem to be deterred by the relatively poor results that have been observed with respect to M&As, particularly in some industries. These include the opening of markets due to the liberalization of trade, investments and capital markets and to deregulation in a number of industries, and fiercer competitive pressures brought about by globalization and technological changes. Under these conditions, expanding firm size and managing a portfolio of locational assets becomes more important for firms, as it enables them to take advantage of resources and markets world-wide. The search for size is also driven by the search for financial, managerial and operational synergies, as well as economies of scale. Finally, size puts firms in a better position to keep pace with an uncertain and rapidly evolving technological environment, a crucial requirement in an increasingly knowledge-intensive world economy, and to face soaring costs of research. Other motivations include efforts to attain a dominant market position as well as short-term financial gains in terms of stock value. In many instances, furthermore, the dynamics of the process feeds upon itself, as firms fear that, if they do not find suitable partners, they may not survive, at least in the long run.

... while the developing regions present a diverse picture. FDI flows into Latin America and the Caribbean rose, ...

Despite the turbulence in financial markets, FDI flows into Latin America and the Caribbean in 1998 were more than \$71 billion, a five per cent increase over those in 1997. The MERCOSUR countries received almost half of this amount. With more than \$28 billion, Brazil was the largest recipient, followed by Mexico with \$10 billion. As commodity prices fell sharply, portfolio investment dried up, speculative currency attacks multiplied and positive current account balances turned negative, FDI capital inflows served as a stabilizing force for Latin America and the Caribbean overall. Privatization of service or natural-resource state enterprises is still an important driving force of FDI inflows into Latin America and the Caribbean. Large markets, especially those of NAFTA and MERCOSUR, also provided lucrative investment destinations. To the extent that FDI is concentrated in services and other non-tradable industries, profit and dividend remittances, as well as expectation regarding remittances, could have implications for the balance-of-payments of the host countries. In Brazil, for instance, profit and dividend remittances increased by about 18 per cent to an estimated \$7.7 billion in 1998.

The United States remains the largest investor in Latin America and the Caribbean. The European Union, however, has made significant gains as a source of FDI to that region, and is beginning to challenge the traditional dominance of the United States. Spain in particular has been a significant investor, accounting for one third of all European Union FDI in Latin America and the Caribbean in 1997. FDI outflows from Latin America and the Caribbean rose to more than \$15 billion 1998 – but more than two-fifths of that originated from offshore financial centres and cannot therefore be attributed solely to Latin American and Caribbean TNCs. An estimated \$8 billion was invested within the region; Argentinian, Brazilian and Chilean TNCs were especially active in intra-regional FDI.

... compensating partly for a moderate decline in Asia and the Pacific; ...

Although down by 11 per cent to \$85 billion in 1998, FDI flows to Asia and the Pacific appeared to have weathered the financial crisis that threw several Asian countries into turmoil and slashed growth rates. It proved to be the most resilient form of private capital flows, even in some of the countries directly hit by the crisis. Contributing to its resilience were the availability of cheap assets due inter alia to currency devaluations, FDI liberalization, especially as regards M&As, intensified efforts to attract FDI, and the still solid long-term prospects of the region.

China remains the largest FDI host country in the developing Asian region, receiving \$45 billion in 1998. The Republic of Korea saw a dramatic increase in inflows (from less than \$3 billion in 1997 to \$5 billion in 1998) and became a net FDI recipient with FDI inflows exceeding outflows for the first time in the 1990s. Thailand also experienced a dramatic increase in inflows (by 87 per cent in 1998), as a number of weakened financial institutions were acquired by foreign investors. The Philippines also registered large gains. By contrast, Hong Kong (China), Indonesia, Singapore, Taiwan Province of China and Viet Nam suffered declines.

South Asian economies received small FDI flows; India for example was unable to sustain the high rate of FDI growth it had enjoyed in the recent past.

Continuing earlier trends, the Pacific Island economies received about \$175 million in 1998, mostly from Australia, Japan and New Zealand. FDI flows to West Asia remained at a level similar to those of 1997, a year that registered a sharp increase. This was due largely to the low oil prices prevailing in 1998. For the same reason, FDI flows to oil-exporting Central Asian economies lost their growth momentum, but that was partly compensated by increases in the non-oil based economies of Armenia and Georgia.

United States TNCs have been active investors in Asia during the crisis, followed by European TNCs.

Plagued by financing difficulties, TNCs from developing Asian countries decreased their overseas FDI (especially in other Asian countries) by a quarter, investing altogether \$36 billion in 1998. Financing shortages led many companies, especially TNCs based in the Republic of Korea, to slow down the acquisition of foreign companies and even to divest some of their assets abroad.

... Africa is still awaiting the realization of its potential ...

FDI inflows to Africa (including South Africa) — at \$8.3 billion in 1998 — were down from the record \$9.4 billion registered in 1997. This was largely accounted for by a decrease of flows into South Africa where privatization-related FDI — which had reached an unprecedented peak in 1997 — fell back in 1998 to levels of previous years. The rest of the continent registered a modest increase. Overall, Africa benefited from a rise in inward FDI since the early 1990s, but growth in FDI flows to the region was much less than that in FDI flows to other developing countries, leaving much of Africa's potential for FDI unutilized.

A survey of African investment promotion agencies, undertaken by UNCTAD in 1999, indicates where this potential lies, at least in the eyes of those who seek to attract FDI: during 1996-1998, the leading industries that attracted FDI were telecommunications, food and beverages, tourism, textiles and clothing, as well as mining and quarrying. For the years 2000-2003, they are expected to be tourism, food and beverages, telecommunications as well as textile and leather. Independently of specific industries, the five countries that were ranked most attractive to foreign investors in Africa for the period 2000-2003 were South Africa, Nigeria, Botswana, Côte d'Ivoire and Tunisia. The countries that were most frequently mentioned as regards the creation of a business-friendly environment were Botswana, South Africa, Nigeria, Uganda and Côte d'Ivoire. Among the countries that were ranked as the top 10 according to the criterion of a business-friendly environment, six countries - Botswana, Ghana, Mozambique, Namibia, Tunisia and Uganda — had been identified as FDI front-runners in *WIR98* (out of

seven front-runners). The survey, however, also indicated that, in spite of the reforms that have taken place and the progress expected in a number of African countries in terms of improving the business environment, further work is needed to change the image of Africa and to develop among foreign investors a more differentiated view of the continent and its opportunities.

... and flows into Central and Eastern Europe, except the Russian Federation, reached new highs.

Excluding the Russian Federation, Central and Eastern European countries received record FDI inflows of \$16 billion in 1998 — 25 per cent higher than in 1997. The Russian Federation, plagued by low investor confidence, a stagnant privatization programme and dependence on market-oriented investment that suffered a blow from devaluation and economic uncertainty, received only \$2 billion, 60 per cent less than in 1997. In most Central and Eastern European countries, FDI is still privatization-led, although a few countries have started a switch to non-privatization-generated investment.

FOREIGN DIRECT INVESTMENT AND THE CHALLENGE OF DEVELOPMENT

The new competitive context raises new challenges for governments and TNCs ...

The development priorities of developing countries include achieving sustained income growth for their economies by raising investment rates, strengthening technological capacities and skills, and improving the competitiveness of their exports in world markets; distributing the benefits of growth equitably by creating more and better employment opportunities; and protecting and conserving the physical environment for future generations. The new, more competitive, context of a liberalizing and globalizing world economy in which economic activity takes place imposes considerable pressures on developing countries to upgrade their resources and capabilities if they are to achieve these objectives. This new global context is characterized by rapid advances in knowledge, shrinking economic space and rapid changes in competitive conditions, evolving attitudes and policies, and more vocal (and influential) stakeholders.

A vital part of the new context is the need to improve competitiveness, defined as the ability to sustain income growth in an open setting. In a liberalizing and globalizing world, growth can be sustained only if countries can foster new, higher value-added activities, to produce goods and services that hold their own in open markets.

FDI and international production by TNCs can play an important role in complementing the efforts of national firms in this respect. However, the objectives of TNCs differ from those of host governments: governments seek to spur *national* development, while TNCs seek to enhance their own competitiveness in an *international* context. In the new context, TNCs' ownership advantages are also changing. In particular, rapid innovation and deployment of new technologies, in line with logistic and market demands, are more important than ever before. Thus, TNCs have to change their relations with suppliers, buyers and competitors to manage better the processes of technical change and innovation. And they have to strike closer links with institutions dealing with science, technology, skills and information. The spread of technology to, and growth of skills in, different countries means that new TNCs are constantly entering the arena to challenge established ones.

A striking feature of the new environment is how TNCs shift their portfolios of mobile assets across the globe to find the best match with the immobile assets of different locations. In the process, they also shift some corporate functions to different locations within internationally integrated production and marketing systems (intensifying the process of "deep integration"). The ability to provide the necessary immobile assets thus becomes a critical part of an FDI —

and competitiveness — strategy for developing countries. While a large domestic market remains a powerful magnet for investors, TNCs serving global markets increasingly look for world-class infrastructure, skilled and productive labour, innovatory capacities and an agglomeration of efficient suppliers, competitors, support institutions and services. In addition, they may also seek to acquire created assets embodied in competitive host country firms, which may lead to a restructuring of these firms not necessarily beneficial for host countries. Low-cost labour remains a source of competitive advantage for countries, but its importance is diminishing; moreover, it does not provide a base for sustainable growth since rising incomes erode the edge it provides. The same applies to natural resources.

... and meeting them requires policy intervention.

There is no conflict between exploiting static sources of comparative advantage and developing new, dynamic ones; existing advantages provide the means by which new advantages can be developed. A steady evolution from one to the other is the basis for sustained growth. What is needed is a policy framework to facilitate and accelerate the process: this is the essence of a competitiveness strategy. The need for such strategy does not disappear once growth accelerates, or economic development reaches a certain level; it merely changes its form and focus. This is why competitiveness remains a concern of governments in developing and developed countries alike. The starting point for this concern is that providing a level playing field and letting firms respond to market signals is sufficient only to the extent that markets work efficiently. The very existence of TNCs is a manifestation that this is not always the case. In the presence of market failures, e.g. when markets fail to exploit existing endowments fully, fail to develop new competitive advantages, or do not give the correct signals to economic agents so that they can make proper investment decisions, intervention is necessary — provided governments have the capabilities to design, monitor and implement policies that overcome market failures.

More specifically, government policies on FDI need to counter two sets of market failures. The first arises from information or coordination failures in the investment process, which can lead a country to attract insufficient FDI, or the wrong quality of FDI. The second arises when private interests of investors diverge from the economic interests of host countries. This can lead FDI to have negative effects on development, or it may lead to positive, but static benefits that are not sustainable over time. Private and social interests may, of course, diverge for any investment, local or foreign: policies are then needed to remove the divergence for all investors. However, some divergence may be specific to foreign investment. FDI may differ from local investment because the locus of decision-making and sources of competitiveness in the former lie abroad, because TNCs pursue regional or global competitiveness-enhancing strategies, or because foreign investors are less committed to host economies and are relatively mobile. Thus, the case for intervening with FDI policies may have a sound economic basis. In addition, countries consider that foreign ownership has to be controlled on non-economic grounds — for instance, to keep cultural or strategic activities in national hands.

The role of FDI in countries' processes and efforts to meet development objectives can differ greatly across countries, depending on the nature of the economy and the government. One vision — pursued, for example, by Malaysia, Singapore and Thailand — was to rely substantially on FDI, integrating the economy into TNC production networks and promoting competitiveness by upgrading within those networks. Another vision — pursued by the Republic of Korea and Taiwan Province of China — was to develop domestic enterprises and autonomous innovative capabilities, relying on TNCs mainly as sources of technology, primarily at arm's length. Yet another, that of the administration of Hong Kong (China), was to leave resource allocation largely to market forces, while providing infrastructure and governance. There is no ideal development strategy with respect to the use of FDI that is common for all countries at all times. Any good strategy must be context specific, reflecting a country's level of economic development, the resource base, the specific technological context, the competitive setting, and a government's capabilities to implement policies.

FDI comprises a package of resources ...

Most developing countries today consider FDI an important channel for obtaining access to resources for development. However, the economic effects of FDI are almost impossible to measure with precision. Each TNC represents a complex package of firm-level attributes that are dispersed in varying quantities and quality from one host country to another. These attributes are difficult to separate and quantify. Where their presence has widespread effects, measurement is even more difficult. There is no precise method of specifying a counter-factual – what would have happened if a TNC had not made a particular investment. Thus, the assessment of the development effects of FDI has to resort either to an econometric analysis of the relationships between inward FDI and various measures of economic performance, the results of which are often inconclusive, or to a qualitative analysis of particular aspects of the contribution of TNCs to development, without any attempt at measuring costs and benefits quantitatively.

FDI comprises a bundle of assets, some proprietary to the investor. The proprietary assets, the “ownership advantages” of TNCs, can be obtained only from the firms that create them. They can be copied or reproduced by others, but the cost of doing that can be very high, particularly in developing countries and where advanced technologies are involved. Non-proprietary assets – finance, many capital goods, intermediate inputs and the like – can usually be obtained from the market also.

The most prized proprietary asset is probably technology. Others are brand names, specialized skills, and the ability to organize and integrate production across countries, to establish marketing networks, or to have privileged access to the market for non-proprietary assets (e.g. funds, equipment). Taken together, these advantages mean that TNCs can contribute significantly to economic development in host countries – if the host country can induce them to transfer their advantages in appropriate forms and has the capacity to make good use of them. The assets in the FDI bundle are:

- **Capital:** FDI brings in investible financial resources to host countries. FDI inflows are more stable and easier to service than commercial debt or portfolio investment. In distinction to other sources of capital, TNCs typically invest in long-term projects.
- **Technology:** TNCs can bring modern technologies, some of them not available in the absence of FDI, and they can raise the efficiency with which existing technologies are used. They can adapt technologies to local conditions, drawing upon their experience in other developing countries. They may, in some cases, set up local R&D facilities. They can upgrade technologies as innovations emerge and consumption patterns change. They can stimulate technical efficiency and technical change in local firms, suppliers, clients and competitors, by providing assistance, by acting as role models and by intensifying competition.
- **Market access:** TNCs can provide access to export markets, both for goods (and some services) that are already produced in host countries, helping them switch from domestic to international markets; and for new activities that exploit a host economy’s comparative advantages. The growth of exports itself offers benefits in terms of technological learning, realization of scale economies, competitive stimulus and market intelligence.
- **Skills and management techniques:** TNCs employ and have world-wide access to individuals with advanced skills and knowledge and can transfer such skills and knowledge to their foreign affiliates by bringing in experts and by setting up state-of-the-art training facilities. Improved and adaptable skills and new organizational practices and management techniques can yield competitive benefits for firms as well as help sustain employment as economic and technological conditions change.
- **Environment:** TNCs are in the lead in developing clean technologies and modern environmental management systems. They can use them in countries in which they operate.

Spillovers of technologies and management methods can potentially enhance environmental management in local firms within the industries that host foreign affiliates.

While TNCs offer the potential for developing countries to access these assets in a package, this does not necessarily mean that simply opening up to FDI is the best way of obtaining or benefiting from them. The occurrence of market failures mentioned above means that governments may have to intervene in the process of attracting FDI with measures to promote FDI generally or measures to promote specific types of FDI. Furthermore, the complexity of the FDI package means that governments face trade-offs between different benefits and objectives. For instance, they may have to choose between investments that offer short as opposed to long-term benefits; the former may lead to static gains, but not necessarily to dynamic ones.

The principal issues to be addressed by governments fall into the following four groups:

- Information and coordination failures in the international investment process.
- Infant industry considerations in the development of local enterprises, which can be jeopardized when inward FDI crowds out those enterprises.
- The static nature of advantages transferred by TNCs where domestic capabilities are low and do not improve over time, or where TNCs fail to invest sufficiently in raising the relevant capabilities.
- Weak bargaining and regulatory capabilities on the part of host country governments, which can result in an unequal distribution of benefits or abuse of market power by TNCs.

... the benefits of which can be reaped through policy measures ...

While the ultimate attraction for FDI lies in the economic base of a host country and FDI-attracting efforts by themselves cannot compensate for the lack of such a base, there remains a strong case for proactive policies to attract FDI. Countries may not be able to attract FDI in the volume and quality that they desire and that their economic base merits, for one or more of the following principal reasons:

- *High transaction costs.* While most FDI regimes are converging on a similar set of rules and incentives, there remain large differences in how these rules are implemented. The FDI approval process can take several times longer, and entail costs many times greater in one country than in another with similar policies. After approval, the costs of setting up facilities, operating them, importing and exporting goods, paying taxes and generally dealing with the authorities can differ enormously.
- Such costs can, other things being equal, affect significantly the competitive position of a host economy. An important part of a competitiveness strategy thus consists of *reducing unnecessary, distorting and wasteful business costs*, including, among others, administrative and bureaucratic costs. This affects both local and foreign enterprises. However, foreign investors have a much wider set of options before them, and are able to compare transaction costs in different countries. Thus, attracting TNCs requires not just that transaction costs be lowered, but also, increasingly, that they be benchmarked against those of competing host countries. One important measure that many countries take to ensure that international investors face minimal costs is to set up one-stop promotion agencies able to guide and assist them in getting necessary approvals. However, unless the agencies have the authority needed to provide truly one-stop services, and unless the rules themselves are clear and straightforward, this may not help.
- Despite their size and international exposure, TNCs face *market failures in information*. Their information base is far from perfect, and the decision-making process can be subjective and biased. Taking economic fundamentals as given, it may be worthwhile for a country

that receives lower FDI than desired to invest in establishing a distinct image of its own and, if necessary, attempt to alter the perception of potential investors by providing more and better information. Such promotion efforts are highly skill-intensive and potentially expensive, and they need to be mounted carefully to maximize their impact. Investor targeting — general, industry-specific or company specific — could be a cost-effective approach in some cases. Targeting or information provision is *not* the same as giving financial or fiscal incentives. In general, incentives play a relatively minor role in a good promotion programme, and good, long-term investors are not the ones most susceptible to short-term inducements. The experiences of Ireland, Singapore — and, more recently, Costa Rica — suggest that promotion and targeting can be quite effective in raising the inflow of investment and its quality.

Effective promotion should go beyond simply “marketing a country”, into coordinating the supply of a country’s immobile assets with the specific needs of targeted investors. This addresses potential failures in markets and institutions — for skills, technical services or infrastructure — in relation to the specific needs of new activities targeted via FDI. A developing country may not be able to meet, without special effort, such needs, particularly in activities with advanced skill and technology requirements. The attraction of FDI into such industries can be greatly helped if a host government discovers the needs of TNCs and takes steps to cater to them. The information and skill needs of such coordination and targeting exceed those of investment promotion *per se*, requiring investment promotion agencies to have detailed knowledge of the technologies involved (skill, logistical, infrastructural, supply and institutional needs), as well as of the strategies of the relevant TNCs.

... that also minimize the adverse effects on domestic enterprise development.

Domestic enterprise development is a priority for all developing countries. In this regard, the possible “crowding out” of domestic firms by foreign affiliates is frequently an issue of concern. Crowding out due to FDI could occur in two ways: first, in the product market, by adversely affecting learning and growth by local firms in competing activities; second, in financial or other factor markets, by reducing the availability of finance or other factors, or raising costs for local firms, or both.

The first issue reflects “infant industry” considerations, but without the usual connotation of protecting new activities against import competition. It concerns the fostering of learning in domestic firms *vis-à-vis* foreign firms. FDI can abort or distort the growth of domestic capabilities in competing firms when direct exposure to foreign competition prevents local enterprises from undertaking lengthy and costly learning processes. Foreign affiliates also undergo learning locally to master and adapt technologies and train employees in new skills. However, they have much greater resources to undertake this learning, and considerably more experience of how to go about learning in different conditions. In these cases, “crowding out” can be said to occur if potentially competitive local firms cannot compete with affiliates at a given point in time.

The case for domestic enterprise protection differs from the infant industry argument for trade protection. When trade protection is eliminated, consumers benefit from cheaper imports and greater product variety; but some domestic production and employment can be lost. In contrast, in the case of local enterprise protection, the absence of such protection from FDI competition does not lead to loss of domestic production and employment in exchange for enhancing consumer benefits; but, indigenous entrepreneurial development may be hampered, particularly in sophisticated activities. The net cost of this is that linkages may be fewer and technological deepening may be inhibited. As with all infant industry arguments, crowding out is economically undesirable if three conditions are met. First, infant local enterprises are able to mature to full competitiveness if sheltered against foreign competition that takes place through (in this case) FDI. Second, the maturing process does not take so long that the discounted present social costs outweigh the social benefits. Third, even if there are social costs, there must be external benefits that outweigh them.

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

TNCs, however, can also “crowd in” local firms if they strike up strong linkages with domestic suppliers, subcontractors and institutions. Crowding in can take place when foreign entry increases business opportunities and local linkages, raises investible resources or makes factor markets more efficient. Such stimulating effects are most likely when FDI concentrates in industries that are undeveloped in (or new to) host countries. Where local firms are well developed, but still face difficulties in competing with foreign affiliates, there can be harmful crowding out. However, local firms can also become suppliers to TNCs, or be taken over by them, as discussed below.

A second variety of crowding out reflects an uneven playing field for domestic firms because of a segmentation in local factor markets: TNCs may have privileged access to factors such as finance (which may give them a special advantage especially *vis-à-vis* local firms) and skilled personnel because of their reputation and size. They can thus raise entry costs for local firms, or simply deprive them of the best factor inputs.

Both forms of crowding out raise policy concerns. Most governments wish to promote local enterprises, particularly in complex and dynamic industrial activities. Many feel that the deepening of capabilities in local firms yields greater benefits than receiving the same technologies from TNCs: linkages with local suppliers are stronger, there is more interaction with local institutions, and where innovatory activities take place, knowledge developed within firms is not “exported” to parent companies and exploited abroad, and so on. The few developing economies that have developed advanced indigenous technological capabilities have restricted the entry of FDI (generally, or into specific activities). The possession of a strong indigenous technology base is vital not just for building the competitiveness of local enterprises – it is also important for attracting high-technology FDI and for R&D investments by TNCs.

At the same time, there are risks in restricting FDI *per se* to promote local enterprises. For one thing, it is very difficult in practice to draw the distinction between crowding out and legitimate competition. If policy makers cannot make this distinction, they may prop up uneconomic local firms for a long period, at heavy cost to domestic consumers and economic growth. The danger of technological lags if TNCs are kept out of sophisticated activities in a country is much greater now than, say, several decades ago. So is the risk of being unable to enter export markets for activities with high product differentiation and internationally integrated production processes. It is important however, to strengthen the opportunities for domestic firms to crowd in after the entry of FDI by building up local capabilities and a strong group of small- and medium-sized domestic firms that could develop linkages with foreign affiliates.

The right balance of policies between regulating foreign entry and permitting competition depends on the context. Only a few developing countries have built impressive domestic capabilities and world-class innovative systems while restricting the access of TNCs. Some others have restricted foreign entry, but have not succeeded in promoting competitive domestic enterprises in high-technology manufacturing activities. Success clearly depends on many other things apart from sheltering learning, including the availability of complementary resources and inputs, the size of the domestic market and the competitive climate in which learning takes place. In sum, the infant enterprise argument remains valid, and can provide a case for policy

intervention to promote local capability development, but interventions have to be carefully and selectively applied, monitored, and reversed where necessary.

Similar considerations to those highlighted above apply to M&As of local firms by TNCs, including privatization by sale of state enterprises to foreign investors, a common form of foreign entry into Latin America and Central and Eastern Europe, and more recently into developing Asian countries affected by the financial crisis. Some M&As that entail a simple change of ownership akin to portfolio investment can be of lesser developmental value. Some take-overs lead to asset stripping, and large M&A-related inflows can become large outflows when investments are liquidated, possibly giving rise to exchange rate volatility and discouraging productive investment. There may also be adverse effects on local innovatory capacity and competitiveness in trade as illustrated by the acquisition of firms in the automotive and telecommunications industries of Brazil by TNCs. These resulted in a scaling down of R&D activities in the acquired firms. Reduced reliance by Brazilian firms acquired by TNCs on locally produced high-technology inputs also led to increased import penetration in areas such as in automobile parts and components, information technology and telecommunication products. Many countries, including developed ones, are also concerned about the adverse impact of M&As on employment. M&As can also have anti-competitive effects if they reduce substantially the number of competitors in a domestic market, especially for non-tradable products such as most services.

M&As may also yield economic benefits, however. Where the investor makes a long-term commitment to the acquired firm and invests in upgrading and restructuring its technology and management, the impact is very similar to a greenfield investment. In Thailand, for instance, in the context of the recent financial crisis, a number of M&As in the automobile industry are leading to restructuring and increased competitiveness, manifested by increases in commercial vehicle exports. FDI related to M&As can play an important role in modernizing privatized utilities such as telecommunications and public utilities, as is the case in some instances in Latin America. Foreign acquisitions can prevent viable assets of local firms from being wiped out; this can be particularly important in economies in transition and financially distressed developing countries.

The benefits of M&As (including in the context of privatization) depend on the circumstances of a country and the conditions under which enterprises are acquired and subsequently operated. However, there may be value in monitoring M&As, instituting effective competition policies, and placing limits on them when the macroeconomic situation justifies it.

This raises the question of the effects of FDI on market structure in host countries. There has been a long-standing concern that the entry of large TNCs raises concentration levels within an economy and can lead to the abuse of market power. TNCs tend to congregate in concentrated industries. Whether this leads to the abuse of market power is an empirical question requiring further research. If host economies have liberal trade regimes, the danger of anti-competitive behaviour in such structures is largely mitigated. However, it remains true that effective competition policy becomes more and more important in a world in which large TNCs can easily dominate an industry in a host country.

Positive dynamic FDI effects on host countries require appropriate skills and policies, ...

Many important issues concerning the benefits of FDI for technology acquisition and technological capacity-building, skills development and competitiveness revolve around its static versus dynamic effects. TNCs can be efficient vehicles for the transfer of technologies and skills suited to *existing* factor endowments in host economies. They provide technology at very different levels of scale and complexity in different locations, depending on market orientation and size, labour skills available, technical capabilities and supplier networks. Where the trade regime in host (and home) countries is conducive (and infrastructure is adequate), they can use local endowments effectively to expand exports from host countries. This can create new capabilities

in the host economies and can have beneficial spillover effects. In low-technology assembly activities, the skills and linkage benefits may be low; in high-technology activities, however, they may be considerable. Unless they operate in highly protected regimes, pay particularly low wages (as in some export processing zones in low-skill assembly), or benefit from expensive infrastructure while paying no taxes, there is a strong presumption that FDI contributes positively to using host country resources efficiently and productively.

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

The development impact of FDI, however, also depends on the *dynamics* of the transfer of technology and skills by TNCs: how much upgrading of local capabilities takes place over time, how far local linkages deepen, and how closely affiliates integrate themselves in the local learning system. TNCs may simply exploit the existing advantages of a host economy and move on as those advantages erode. Static advantages may not automatically transmute into dynamic advantages. This possibility looms particularly large where a host economy's main advantage is low-cost unskilled labour, and the main TNC export activity is low-technology assembly.

The extent to which TNCs dynamically upgrade their technology and skills transfer and raise local capabilities and linkages depends on the interaction of the trade and competition policy regime, government policies on the operations of foreign affiliates, the corporate strategies and resources of TNCs, and the state of development and responsiveness of local factor markets, firms and institutions.

- The *trade and competition policy regime* in a host economy may provide the encouragement for enterprises, local and foreign, to invest in developing local capabilities. In general, the more competitive and outward-oriented a regime, the more dynamic is the upgrading process. A highly protected regime, or a regime with stringent constraints on local entry and exit, discourages technological upgrading, isolating the economy from international trends. This is not to say that completely free trade is the best setting. Infant industry considerations suggest that some protection of new activities can promote technological learning and deepening. However, even protected infants must be subjected to the rigours of international competition fairly quickly – otherwise they will never grow up. This applies to foreign affiliates, as well as to local firms. A strongly export-oriented setting with appropriate incentives provides the best setting for rapid technological upgrading.
- The second factor concerns *policies regarding the operations of foreign affiliates*, including local-content requirements, incentives for local training or R&D, and pressures to diffuse technologies. The results of the use of such policies have often been poor when they were not integrated into a wider strategy for upgrading capabilities. However, where countries have used them as part of a coherent strategy, as in the mature newly-industrializing economies, the results have often been quite beneficial: foreign affiliates enhanced the technology content of their activities and of their linkages to local firms, which were supported in raising their efficiency and competitiveness. Much of the effort by foreign affiliates to upgrade local capabilities involves extra cost, and affiliates will not necessarily undertake this effort unless it is cost effective and suits their long-term objectives. For the host economy, it is worth doing so only if it leads to efficient outcomes. If upgrading is forced beyond a country's capabilities, it will not survive in a competitive and open environment.

- The third factor involves *TNC strategies*. Corporate strategies differ in the extent to which they assign responsibility to different affiliates and decide their position in the corporate network. TNCs are changing their strategies in response to technological change and policy liberalization, and much of this is outside the scope of influence of developing host countries. Nevertheless, host country governments can influence aspects of TNC location decisions by measures such as targeting investors, inducing upgrading by specific tools and incentives and improving local factors and institutions. This requires them to have a clear understanding of TNC strategies and their evolution.
- The fourth factor, the state and responsiveness of *local factor markets, firms and institutions*, is probably the most important one. TNCs upgrade their affiliates where it is cost-efficient to do so. Moreover, since firms in most industries prefer their suppliers to be nearby, they will deepen local linkages if local suppliers can respond to new demands efficiently. Both depend upon the efficacy and development of local skills and technological capabilities, supplier networks and support institutions. Without improvements in factor markets, TNCs can improve the skills and capabilities of their employees only to a limited extent. They do not compensate for weaknesses in the local education, training and technology system. In the absence of rising skills and capabilities generally, it would be too costly for them to import advanced technologies and complex, linkage-intensive operations.

At the same time, there are risks that the presence of TNCs inhibits technological development in a host economy. TNCs are highly efficient in transferring the results of innovation performed in developed countries, but less so in transferring the innovation process itself. While there are some notable exceptions, foreign affiliates tend to do relatively little R&D. This may be acceptable for a while in the case of countries at low levels of industrial development, but can soon become a constraint on capability building as countries need to develop autonomous innovative capabilities. Once host countries build strong local capabilities, TNCs can contribute positively by setting up R&D facilities. However, at the intermediate stage, the entry of large TNCs with ready-made technologies can inhibit local technology development, especially when local competitors are too far behind to gain from their presence. Where a host economy adopts a proactive strategy to develop local skills and technology institutions, it may be able to induce TNCs to invest in local R&D even if there is little research capability in local firms. The appropriate policy response is not to rule out FDI, but to channel it selectively so that local learning is protected and promoted. In countries that do not restrict FDI, it is possible to induce advanced TNC technological activity by building skills and institutions.

... as well as strong bargaining capabilities, regulatory regimes and policy-making capacity.

In some cases, the outcome of FDI depends significantly on how well a host economy bargains with international investors. However, the capacity of developing host countries to negotiate with TNCs is often limited. The negotiating skills and information available to TNCs tend to be of better quality. With growing competition for TNC resources, the need of many developing countries for the assets TNCs possess is often more acute than the need of TNCs for the locational advantages offered by a specific country. In many cases, particularly in export-oriented investment projects where natural resources are not a prime consideration, TNCs have several alternative locations. Host countries may also have alternative foreign investors, but they are often unaware of them. Where the outcome of an FDI project depends on astute bargaining, developing host countries may sometimes do rather poorly compared to TNCs. The risk is particularly great for major resource-extraction projects or the privatization of large public utilities and other companies. Considerable bargaining also takes place in large manufacturing projects where incentives, grants and so on are negotiated on a case-by-case basis. Though the general trend is towards non-discretionary incentives, considerable scope for bargaining still exists, and developing countries tend to be at a disadvantage in this respect.

To strengthen developing countries' bargaining capabilities, legal advice is often required, but the costs of obtaining such advice are usually prohibitive, especially for least developed countries. Establishing a pilot facility that would help ensure that expert advice in contract negotiations is more readily available to developing countries is worth considering. Such a facility would benefit not only developing host countries, but also TNCs by reducing specific transaction costs in the process of negotiations (for instance, by reducing the risk of delays) and, more generally, by leading to more stable and lasting contracts.

To return to the regulatory framework: with liberalization and globalization, there are fewer policy tools available to countries left to influence the conduct of foreign and local firms. The capacities of host developing countries to regulate enterprises in terms of competition policy and environment policy are emerging as the most active policy-making areas. An effective competition policy is therefore an absolute necessity. However, most developing countries lack such policy. Mounting a competition policy is a complex task requiring specialized skills and expertise that are often scarce in developing countries. It is important for host countries to start the process of developing these skills and expertise, especially if large TNCs with significant market power are attracted to their markets.

Similar concerns arise with respect to the environment. Many developing host countries have only limited regulations on the environment, and often lack the capacity to enforce them effectively. TNCs are often accused of exploiting these in order to evade tougher controls in the developed world. Some host developing countries are accused of using lax enforcement to attract FDI in pollution-intensive activities. The evidence on the propensity of TNCs to locate their investments in order to evade environmental regulations is, however, not conclusive. TNCs are usually under growing pressure to conform to high environmental standards from home country environmental regulations, consumers, environment groups and other "drivers" in the developed and developing world. Many see environment management not only as necessary, but also as commercially desirable. However, it is up to host governments to ensure that all TNCs and domestic firms follow the examples set by the "green" TNCs.

Another important regulatory problem is that of transfer pricing to evade taxes or restrictions on profit remission. TNCs can use transfer pricing over large volumes of trade and service transactions. The problem is not restricted to dealings between affiliates; it may also arise in joint ventures. However, it may well be that the deliberate abuse of transfer pricing has declined as tax rates have fallen and full profit remittances are allowed in much of the developing world. Double-taxation treaties between host and home countries have also lowered the risk of transfer-pricing abuses. However, this problem still remains a widespread concern among developed and developing countries. Tackling it needs considerable expertise and information. Developing country tax authorities are generally poorly equipped to do this, and can benefit greatly from technical assistance and information from developed-country governments in this area.

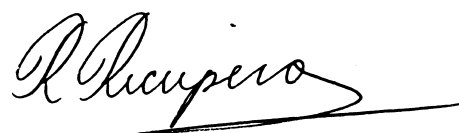
Managing FDI policy effectively in the context of a broader competitiveness strategy is a demanding task. A passive, *laissez faire* approach is unlikely to be sufficient because of failures in markets and deficiencies in existing institutions. Such an approach may not attract sufficient FDI, extract all the potential benefits that FDI offers, or induce TNCs to operate by best-practices standards. However, a *laissez faire* FDI strategy may yield benefits in host countries that have under-performed in terms of competitiveness and investment attraction because of past policies. Such a strategy sends a strong signal to the investment community that the economy is open for business. FDI will be attracted into areas of existing comparative advantage. However, there are two problems. First, if attractive locational assets are limited, or their use is held back by poor infrastructure or non-economic risk, there will be little FDI response. Second, even if FDI enters, its benefits are likely to be static and will run out when existing advantages are used up. To ensure that FDI is sustained over time and enters new activities requires policy intervention, both to target investors and to raise the quality of local factors. Needless to say, for the great majority of countries the form of intervention has to be different from traditional patterns of heavy inward-orientation and market-unfriendly policies – it has to be aimed at competitiveness.

What all this suggests is that there is no ideal universal strategy on FDI. Any strategy has to suit the particular conditions of a country at any particular time, and evolve as the country's needs and its competitive position in the world change. Increasingly, it also has to take into account the fact that international investment agreements set parameters for domestic policy making. Governments of developing countries need to ensure, therefore, that such agreements do leave them the policy space they require to pursue their development strategies. Formulating and implementing an effective strategy requires above all a development vision, coherence and coordination. It also requires the ability to decide on trade-offs between different objectives of development. In a typical structure of policy making, this requires the FDI strategy-making body to be placed near the head of government so that a strategic view of national needs and priorities can be formed and enforced.

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In conclusion, TNCs are principal drivers of the globalization process, which defines the new context for development. In this context, there is more space for firms to pursue their corporate strategies, and enjoy more rights than before. The obvious question is: should these increased rights be complemented by firms' assuming greater social responsibility? The notion of social responsibility of TNCs encompasses a broad range of issues of which environmental, human and labour rights have attracted most attention in recent years. In a liberalizing and globalizing world economy, this question is likely to be asked with increasing frequency and insistence. In his Davos speech in January 1999, the Secretary-General of the United Nations initiated the discussions on this question by proposing a global compact. Perhaps they could be intensified in the framework of a more structured dialogue between all parties concerned. Development would have to be central to this dialogue, as this is the overriding concern of the majority of humankind and because it is, in any event, intimately linked to the social, environmental and human rights objectives that lead the agenda in this area. The dialogue could build on the proposal of a global compact made by the Secretary-General, with a view towards examining how, concretely, the core principles already identified, as well as development considerations, could be translated into corporate practices. After all, companies can best promote their social responsibilities by the way they conduct their own businesses and by the spread of good corporate practices.

The world today is more closely knit, using different means of organization, communication and production, and is more subject to rapid change than ever before. At the same time, the past 30 years show striking – and growing – differences between countries in their ability to compete and grow. They also show how markets by themselves are not enough to promote sustained and rapid growth: policies matter, as do the institutions that formulate and implement them. There is an important role for government policies, but not in the earlier mould of widespread intervention behind protective barriers. Rather, in a globalizing world economy, governments increasingly need to address the challenge of development in an open environment. FDI can play a role in meeting this challenge. Indeed, expectations are high, perhaps too high, as to what FDI can do. But it seems clear that if TNCs contribute to development – and do so significantly and visibly – the relationship that has emerged between host country governments, particularly in developing countries, and TNCs over the past 15-20 years can develop further with potential benefits for all concerned.


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Secretary-General of UNCTAD

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