FOREIGN DIRECT INVESTMENT: A LEAD DRIVER FOR SUSTAINABLE DEVELOPMENT

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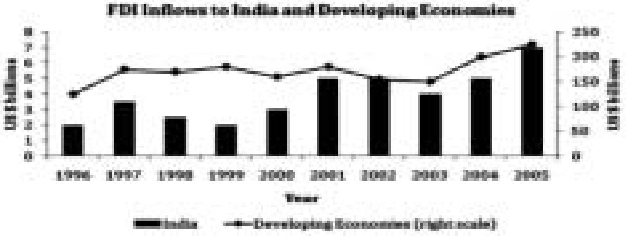
Abstract

Foreign direct investment (FDI) is an integral part of an open and effective international economic system and a major catalyst to development. The role of foreign direct investment (FDI) in driving economic growth and development has been contested one. Countries have liberalized of economic development and modernization, income growth and employment. Some argue that FDI leads to economic growth and productivity increases in the economy as a whole and hence contributes to differences in economic growth and development performances across countries, but others stress the risk of FDI destroying local capabilities and extracting natural resources without adequately compensating poor countries. Developing there have always been views in favor of FDI and against it. Countries, emerging economies and countries in transition have come increasingly to see FDI as a source their FDI regimes and pursued other policies to attract investment. This paper examines trends in the relationship between FDI and development.

***Key Words**: Foreign Direct Investment, Economic Development, Employment, Increase Productivity.*

Introduction

Starting from a baseline of less than $1 billion in 1990, a recent UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010–2012. As per the data, the sectors which attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, the US and the UK were among the leading sources of FDI. FDI in 2010 was $24.2 billion, a significant decrease from both 2008 and 2009. Foreign direct investment in August 2010 dipped by about 60% to approx. $34 billion, the lowest in 2010 fiscal, industry department data released showed. In the first two months of 2010–11 fiscal, FDI inflow into India was at an all-time high of $7.78 billion up 77% from $4.4 billion during the corresponding period in the previous year. The below mentioned diagram represent the FDI inflows to India.



The world's largest retailer Wal-Mart has termed India's decision to allow 51% FDI in multi-brand retail as a "first important step" and said it will study the finer details of the new policy to determine the impact on its ability to do business in India. However this decision of the government is currently under suspension due to opposition from multiple political quarters. The foreign direct investor may acquire voting power of an enterprise in an economy through any of the following methods as such incorporating a wholly owned subsidiary or company; acquiring shares in an associated enterprise; through a merger or an acquisition of an unrelated enterprise; or participating in an equity joint venture with another investor or enterprise.

Foreign direct investment incentives may take the forms of low corporate tax and income tax rates, tax holidays, other types of tax concessions, preferential tariffs, special economic zones, epz – export processing zones, bonded warehouses, maquiladoras, investment financial subsidies, soft loan or loan guarantees, free land or land subsidies, relocation & expatriation subsidies, job training & employment subsidies, infrastructure subsidies, r&d support, and derogation from regulations (usually for very large projects)

The Pros and Cons of FDI as a Source of Development

Attraction of FDI is becoming increasingly important for developing countries. However this is often based on the implicit assumption that greater inflows of FDI will bring certain benefits to the country's economy. FDI, like ODA or any other flow of capital, is simply that, a **source** of capital. However the impact of FDI is dependent on what **form** it takes.

Table 1. Regional Trends and Prospects for FDI

Region	**Inflows**	**Outflows**	**Status and Prospects**
Latin America & Caribbean	Total Inflows (1998): US$ 71 billion. Key receivers: Brazil, Mexico, Argentina, ChileKey Sources: United States, Spain Key Sectors: Services (Business, electricity, finance), Manufacturing (chemicals, food/ beverage/tobacco), Mining.	Total Outflows (1998): US$ 15 billion Key sources: Cayman Islands, Chile, Brazil, Bermuda, Argentina. Receivers: Over 75% re invested in the region.	FDI inflows have steadily risen since 1991 and this is expected to increase. However, current accounts remain in deficit, and human, technical, infrastructural and financial constraints continue to limit attraction of inflows. Domestic markets are still largely geared to short term financing.
Asia & Pacific	Total Inflows: US$ 85 Billion. Key receivers: China, Singapore, Thailand, Korea (Democratic Peoples Republic), Japan. Key Sources: Australia, Japan, New Zealand.Key Sectors: Manufacturing (chemicals, wood, electric), services (transport, real estate).	Total Inflows: US$ 85 Billion. Key sources: Japan, Hong Kong (China), Korea (DPR), Taiwan Province.Receivers: Over 50% of outflows are reinvested in region China.	Although financial crisis in 1996/7 hit many Asian countries (especially Indonesia) others were more resilient (Taiwan Province, China, Hong Kong). Long run growth are re-invested in region, China. is predicted but the region may need diversification to gain greater access to global economy.
Central & Eastern Europe	Total Inflows: US$ 19 billion. Key receivers: Poland, Czech Republic, Russia, Romania, Hungary Key Sources: Europe (Germany, Netherlands) Key Sectors: Mining, metals, food production & services.	Total Outflows: US$ 2 billion. Key Sources Russia, Hungary, poland Receivers: Europe	Resilient and increasing FDI inflow to region, especially compared to portfolio investment and bank loans. Small outward investors lack access to finance. The financial crisis in Russia reduced FDI inflows but longer term outlook is more positive.
Africa	Total Inflows: US$ 8 billion. Key receivers: Nigeria, Egypt, Tunisia, Algeria Key Sources: USA, Belgium, UK, France Key Sectors: Telecomm., food / beverage, tourism, mining/quarrying, textiles	Total Outflows: US$ 0.5 billion. Key sources: South Africa, Liberia, Nigeria Receivers: Namibia, Swaziland	FDI has grown by 6 times in the last 10 years but only in a small number of countries and at a low level compared to international flows. Problems of extortion and corruption indicate a vital need for democratisation, transparent regulation and improved rule of law to support inflows to the region.
North America	Total Inflows: US$ 193 billion. Key Sources: Mainly Europe (especially UK,Germany), Japan Key Sectors: Manufacturing (48%) and petroleum (30%)	Total Outflows: U$ 110 billion. Key sources: USA Receivers: Europe (54%) but also Latin America Key Sectors: Services, banks, finance, insurance, manufacturing	A strong FDI competitor. The distribution of inflows to USA is uneven across states, e.g. Hawaii has very high inflows (tourism). Although high FDI has little contribution to employment levels. Short run growth is predicted but in the medium term as the dollar strengthens inflows may drop.
Western Europe	Total Inflows: US$ 237 billion (1998). Key receivers: UK,Netherlands, France,Belgium. Key Sources: United States, Europe, Japan Key Sectors: Services (finance & trade related), manufacturing (petroleum,chemicals).	Total Outflows: US$ 406 billion Key sources: UK, Germany, France. Receivers:Europe,United States, Japan. Key Sectors: Services (60%, especially finance and trade), manufacturing (petroleum, chemicals)	Finland and Netherlands have seen the highest growth rate of inflows. Other countries, such as Italy, have fallen in recent years. The automobile sector is thought to have potential. The presence of the Single European Currency hasn't yet indicated noticeable benefit to members compared to non-members.

(**Sources:** World Bank a., UNCTAD, ICC)

All these institutions need greater cooperation, coordination and more openly accountable processes to look at how international flows of FDI flows can be better directed toward the specific goals of sustainable development. In relation to monitoring FDI, there is also a need to further develop and apply sustainability indicators to better assess the impacts of FDI for different regions and sectors (Table 2).

Table 2. Examples of Indicators for FDI and Sustainability Sources:

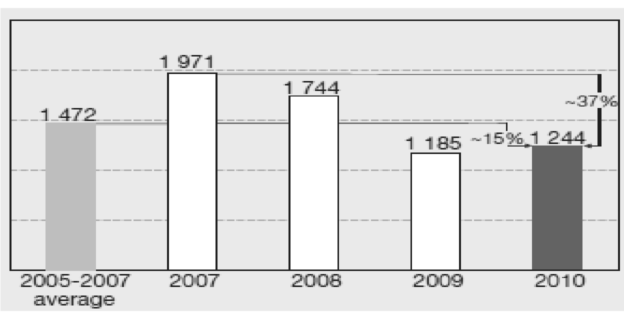
	Type	**Example of indicator**
Economic	Investment and Productivity	Net Foreign Direct Investment (FDI); Net Foreign Direct Investment (FDI) as % of GDP and of GFCP; Net change in foreign investment between the reporting country and the rest of the world; Net resource transfer. Ratio of aggregate Net Resource Transfers (long-term) to GNP (%). R & expenditure from FDI in local economy. % of FDI into Greenfield investments.
	Other financial factors	Ratio of Total Official Development Assistance (ODA) given or received to Gross National Product (GNP) from Bilateral and multilateral sources. Ratio of total external debt to GNP (%), Ratio of total debt service to exports of goods and services, including worker's remittances %. Per capita domestic saving and investment.
Social	Labourstandards and employment	Adoption of ILO labour standards and indicators. % employment in host economy created (directly/indirectly) by FDI.
	Education	Enrolment ratios by level of education, public/private expenditure on education/ training, expected number of years of formal schooling
Environment	Environmental Best Practice	Adoption of environmental management systems, environmental reporting, energy efficiency. Green accounting e.g. "green" net national product (green NNP), genuine savings etc.
	Environmental Protection	% of FDI into environmentally sensitive sectors. Ratio of environmental protection expenditures to Gross Domestic Product (GDP) %. Degree of implementation of Multi-lateral Environmental agreements.

Sources: World Bank a., World Bank b., UNCED, WWF

Developing Countries: A Strong Recovery has Started

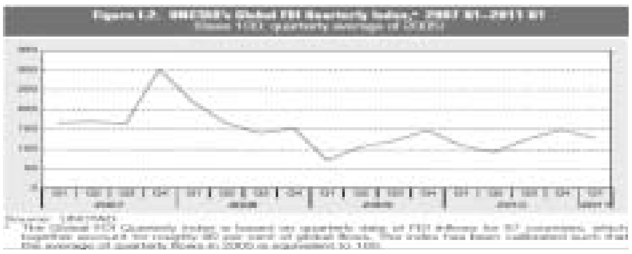
Global foreign direct investment (FDI) inflows rose modestly in 2010, following the large declines of 2008 and 2009. At $1.24 trillion in 2010, they were 5 per cent higher than a year before (figure I.1). This moderate growth was mainly the result of higher flows to developing countries, which together with transition economies – for the first time – absorbed more than half of FDI flows. While world industrial production and trade are back to their pre-crisis levels, FDI flows in 2010 remained some 15 per cent below their pre-crisis average, and 37 per cent below their 2007 peak (figure I.1).

Figure I.1. Global FDI inflows, average 2005–2007 and 2007 to 2010
(Billions of dollars)



Source: UNCTAD, based on annex table I.1 and the FDI/TNC database (www.unctad.org/fdistatistics).

UNCTAD predicts FDI flows will continue their recovery to reach $1.4 –1.6 trillion, or the pre-crisis level, in 2011. In the first quarter of 2011, FDI inflows rose compared to the same period of 2010, although this level was lower than the last quarter of 2010 (figure I.2). They are expected to rise further to $1.7 trillion in 2012 and reach $1.9 trillion in 2013, the peak achieved in 2007.



Current Trends: Global FDI inflows in 2010 reached an estimated $1,244 billion (figure I.1) – a small increase from 2009's level of $1,185 billion. However, there was an uneven pattern between regions and also between sub regions. FDI inflows to developed countries and transition economies contracted further in 2010. In contrast, those to developing economies recovered strongly, and together with transition economies – for the first time – surpassed the 50 per cent mark of global FDI flows (figure I.3).

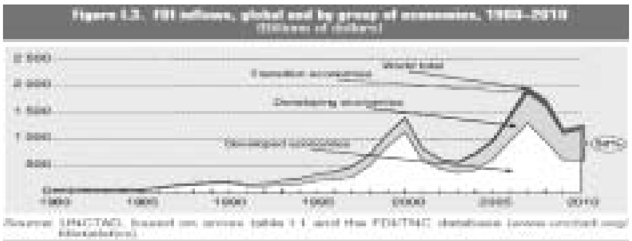
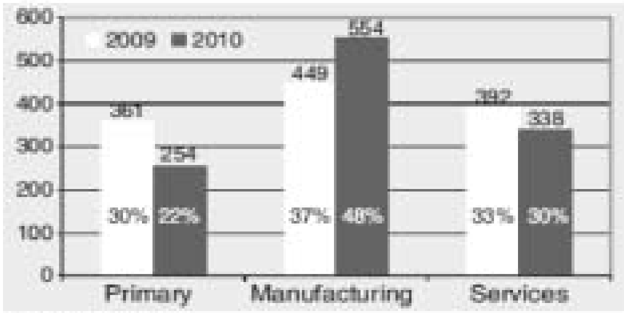


Figure I.3. FDI inflows, global and by group of economies, 1980–2010 (Billions of dollars)

The rise of FDI to developing countries hides significant regional differences. Some of the poorest regions continued to see declines in FDI flows. In addition to least developed countries (LDCs), landlocked developing countries (LLDCs) and small island developing States (SIDS) (chapter II), flows to Africa continued to fall, as did those to South Asia. In contrast, major emerging regions, such as East and South-East Asia and Latin America experienced strong growth in FDI inflows (figure I.6).

FDI by sector and industry: The unchanged level of overall FDI in 2010 also obscures some major sectoral differences. Data on FDI projects (both cross-border M&As and greenfield investment) indicate that the value and share of manufacturing rose, accounting for almost half of the total. The value and share of the primary and services sector declined (figure I.10).

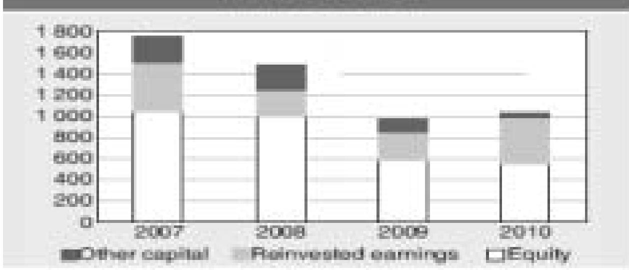
Figure I.10. Sectoral distribution of FDI projects,* 2009–2010 (Billions of dollars and per cent)



Source: UNCTAD.
* Comprises cross-border M&As and greenfield investments. The latter refers to the estimated amounts of capital investment.

FDI by modes of entry: There are diverging trends between the two main modes of FDI entry: M&As and greenfield (new) investment. The value of cross-border M&A deals increased by 36 per cent in 2010, to $339 billion, though it was still roughly one-third of the previous peak in 2007 (figure I.11).

Figure I.12. FDI inflows by component, 2007–2010* (Billions of dollars)



Source: UNCTAD, based on data from FDI/TNC database (www/unctad.org/fdistatistics).
* Based on 106 countries that account for 85 per cent of total FDI inflows during the period 2007-2010.

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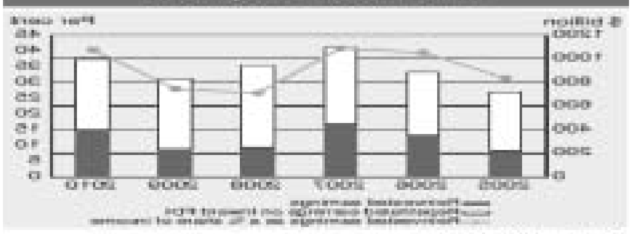
profits of foreign affiliates, lifted reinvested earnings to nearly double their 2009 level (figure I.13).

Figure I.13. FDI income, 2005–2010[a]
(Billions of dollars and per cent)



Source: UNCTAD.
[a] Based on 104 countries that account for 81 per cent of total FDI inflows during the period 2005-2010.

FDI by special funds: private equity and sovereign wealth funds: Private equity-sponsored FDI has regained momentum, although it fell short of its pre-crisis level. It is directed more towards developing and transition economies, secondary buyouts and smaller acquisitions. In 2010, the value of private equity-sponsored cross-border M&As increased by 14 per cent to $122 billion, compared to $107 billion in 2009 after two years of consecutive decline (table I.1).5 At the same time, the corresponding number of cross-border M&As reached a record high, with 2,050 deals completed.

Table I.1. Cross-border M&As by private equity firms, 1996–May 2011
(Number of deals and value)

Year	Number of deals		Value	
	Number	Share in total (%)	$ billion	Share in total (%)
1996	932	16	42	16
1997	925	14	54	15
1998	1 089	14	79	11
1999	1 285	14	89	10
2000	1 340	13	92	7
2001	1 248	15	88	12
2002	1 248	19	85	18
2003	1 488	22	109	27
2004	1 622	22	157	28
2005	1 736	20	207	22
2006	1 698	18	271	24
2007	1 917	18	457	27
2008	1 785	18	322	25
2009	1 993	25	107	19
2010	2 050	22	122	17
2011	591	17	91	20

Source: UNCTAD, cross-border M&A database (www.unctad.org/fdistatistics).
Note: Value is on a gross basis, which is different from other M&A tables based on a net value. The table includes M&As by hedge funds. Private equity firms and hedge funds refer to acquirers as "investors not elsewhere classified". This classification is based on the Thomson Finance database on M&As.

Effects of FDI on Economic Growth

Much has been written about the relationship between FDI and development (UNCTAD, 1999). We review the main impact areas and suggest there have been major changes within these, with an emphasis on how FDI relates to economic growth (we do not deal separately with inequality and poverty).

The areas through which FDI affects development (UNCTAD, 1999) are eEmployment and incomes, capital formation, market access, structure of markets, technology and skills, fiscal revenues, and political cultural and social issues.

These effects can be static and dynamic, and they can be positive and negative. Table 3 draws originally on UNCTAD (1999) and reviews the type of effects in each of the areas. Over the past decades, there have been several major shifts in relation to the impacts discussed in Table 3. First, in parallel to shifts in the nature and composition of FDI, the type and direction of impacts have changed. Secondly, the literature on the macro effects of FDI has evolved and become more sophisticated and nuanced over time. And thirdly, governments have increasingly realized that they can influence the types and direction of impacts through the appropriate mix of policies, and they have increasingly made use of such policies. At the same time, some policies used in the past are now regulated in various international treaties (see below).

Impact Shift 1: The type and "real" direction of impacts have changed

Impact Shift 2: The macro-economic studies on impact of FDI have become more sophisticated and nuanced

Impact shift 3: Increased awareness that policies affect the FDI-growth nexus

Table 3

Inward Foreign Direct Investment and Economic Development

	Static effects		Dynamic effects		
Impact Area	**Indicators**	**Differences b/w foreign and local firms**	**Potential dynamic benefits of FDI**	**Potential dynamic costs of FDI**	**Indicators**
Employment and Income	Employment generation inside foreign firms wage levels for staff with given characteristics	Foreign firms are larger and pay higher wages (especially for skilled employees) than local firms.	Provide income and employment directly	existing employment or pushing up factor prices; may lead toMay indirectly crowd-out other employment by replacing increased wage inequality.	Long-run employment generation inside firm and in suppliers and buyers
Physical capital	Fixed capital formation Financial transfers	Foreign firms tend to be more capital intensive	Stable source of external finance, improving the balance of payments, and potentially raising fixed capital formation.	May pre-empt investment and opportunities of domestic firms.	Long-run relationship between FDI and domestic capital formation
Market access	Share of inputs imported Share of output exported	Foreign firms tend to be more trade intensive	Firms can gain access to export markets by using global networks of TNCs.	TNCs can maintain tight controls of export channels.	Long-run relationship between exports and FDI, and between imports and FDI
Structure of factor and product	Concentration in product and factor market, profit margin	Foreign firms can often be found in sectors with 'barriers to entry'.	Entry by foreign firm may lead to more competition. This may reduce product prices.	The entry of foreign firms can lead to further concentration and market power. This may raise prices of own and other products.	Long-run relationship between FDI and profitability.
Poverty	Combination of how above indicators affect the poor Social investment Core health, environmental and infrastructure programmes		If the effects in this column are important, this provides an enabling environment thereby directly and indirectly alleviating poverty.	If the effects in this column are important, this provides a disabling environment thereby directly and indirectly worsening poverty.	Combination of the above indicators Long-run effect of social investment Lon-run effect of core health, environmental and infrastructure programmes
Political, social and cultural issues			Foreign firms can expose host country to other norms and values, e.g. environmental management, ethics.	Foreign firms may lead to political, social and cultural problems, by imposing unacceptable values (labour and environmental standards) interfering with political regime,and are said to exacerbate existing problems of corruption.	

Fiscal revenues	Fiscal payments Grants to foreign firms	Tax holidays or outright grants are sometimes offered to foreign firms	TNCs can raise fiscal revenues for the domestic government through the payment of taxes in case of new economic activities with more value added.	if TNCs crowd out domestic firms, fiscal revenues may actually be lower through the use of special tax concessions, eventually leading to an erosion of the tax base. Special tax concessions are an implicit subsidy and in case of lack of ransparency can lead to rent-seeking behaviour.	Long-run fiscal payments through foreign firms and through a change in economic activity more generally.
Technology, skills and management techniques	Skill level of emplo yees, Training budgets, Output per employee, R&D budgets, Types of technologies used	Foreign firms are more skill intensive, tend to use more up-to-date technologies and train more.	Provides up to date techniques, skilled personnel and advanced management techniques, raising the return to skills offering additional incentives for education. Positive spillover effects on domestic firms through backward and forward linkages,demonstration effects and human resource development.	Spillovers are not automatic or free. Reliance on foreign technology and skills may inhibit development of local capabilities. Increased linkages raise dependency of domestic firms on TNCs.	Intra and extra-sectoral spillover effects on productivity in other firms. Share of inputs sourced locally Supplier development Upgrading and long-run development of technology, training and skill levels in foreign firms

Source: Duplicated from Te Velde (2004) building on table in UNCTAD (1999)

Conclusions

This paper has discussed trends in FDI and development from an historical perspective. The level and relative importance of FDI has fluctuated over time, and was high in the early part of the 20th century, low in the middle part and growing and high towards the end. Recently there has been an increase in FDI to developing countries, though concentrated in a few regions and countries. Inward FDI to developing countries has always been concentrated in a handful of countries, in part reflecting their economic wealth, but also reflecting the ability of countries to create the conditions that efficiency and strategic asset seeking FDI need, including appropriate and good quality human resource and technological capabilities. All in all, there has been a marked shift towards liberalization of the FDI regime, and FDI is regarded more favorably now than a couple of decades ago. Governments have also realized that policies can influence the effects of FDI on development.

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