Incoming Foreign Investment: holly water or menu of potential troubles?

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Economic theory provides conflicting predictions concerning the effects of direct foreign investments. There are scientists and schools, mainly representatives of liberal and neo-liberal approach, who advocate free economic run and implicitly free flow of capital. This point of view was on its highest in the middle of the twentieth century and proved to be proved to be dangerous and crisis-enhancing in the first decade of the twenty-first century.

On the other hand, there are scientists and schools, representatives of Keynesian school, who provide more critical and more realistic approach (Blackmann, A., Wu, X., Razin, A., Sadka, E., Hausmann, R., Xan X.Vo and others).

Pro-FDI scientists and policy makers have a number of arguments when praising foreign direct investment. They argue that incoming foreign capital ensures economic efficiency firstly, via new jobs created, secondly, via enabled technology transfer; thirdly, via encouraged competition in domestic markets; fourthly, via human capital development as foreigners engage (more) in employee training.

One more argument is often used in favour of foreign direct investment, namely that FDI has an advantage over other investment forms (portfolio or loans) as it proved to be more resilient in times of economic crisis.

On an empirical level, there is a body of evidence that suggests possible positive correlation between FDI and economic growth in developing countries. Yet, while much evidence indicates a one-way causality between FDI and growth, there are many indications that the causality may run both ways. Benefits brought by some foreign investment in one country it does not necessary mean that the same will happen in another one. Methods that gave same positive effects in North Africa might prove as unsuitable when investing in Eastern Europe.

Increased competition may be beneficial for the host economy, or it may not. International corporations may push out national businesses if they are yet not able to compete. In that case many jobs might be lost instead of creating. Foreign flow of capital might spread good practices of corporate governance, accounting rules, and legal traditions, and it may also not. Incoming FDI can limit ability of local government to implement bad policies but it might also result in encouraging host government to implement bad policies and so to spread bad practices instead.

According to the dependency school, in the long-run, FDI tends to impede economic growth and development of recipient economies.

The evidence appears that FDI is favourable to economic welfare only if appropriate conditions exist in the host economy. This includes such factors as adequate absorptive capacity and human capital, a capacity of domestic businesses to face and hold out foreign competition, a capacity of local government to make rational and transparent decisions, abundance of projects and market gaps that cannot to be filled up by home producers etc.

Thus it seems convenient to look deeper into the world practice by measuring the effects of FDI.

Keywords: international economics, foreign direct investment, economic effects of incoming foreign capital, FDI policies.

Introduction

The attraction of foreign capital, especially in the form of direct investments is often underlined as precondition for a successful economic venue by most governments in less-developed economies. Strategists in highly-developed countries seem to be more cautious. Loudly arguing for a free movement of capital governments of stronger economies do a lot in restricting the entrance of foreign investors to their domestic markets.

Moreover, maybe they have a good reason for doing so. The economic rationale for offering special incentives to attract FDI derives from the belief that it will facilitate faster economic growth; produce externalities in the form of larger employment, technology transfers, skills to local producers etc.

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Moreover, maybe they have a good reason for doing so. The economic rationale for offering special incentives to attract FDI derives from the belief that it will facilitate faster economic growth; produce externalities in the form of larger employment, technology transfers, skills to local industry, boosted productivity or filled “idea gaps” between rich and poor countries. But the world economic literature and numerous empirical researches proved that positive effects of FDI are often overwhelmed by negative ones.

There are market failures, different conditions in receiving countries, different absorption capacity, different level of development or maybe imperfect information, all this has to be taken into the consideration while setting an appropriate strategy towards foreign investments. One size can not fit all.

The literature on FDI began in the late seventies with Dunning (1981) and was mainly focused on the creation of multinational enterprises and the firm’s opportunities to become one of them (Arbesser, 2002).

In about a decade the researchers shifted to discuss the benefits of FDI to the recipient countries. Most significant outcomes were that FDI quite often has a negative welfare
impact instead of positive one’s to a host country (Hausmann, 2002).

The financial crisis that hit most emerging economies in the 1990 caused another shift in the literature of FDI. The discussion was focused more on correlation between the composition of international capital flows and crisis. The idea that crises are largely due to deregulation of a banking sector and swings in short term capital proved itself as rational if to look at the causalities of the recent economic decline (Ucal, Ozcan, Bilgin & Mungo, 2010).

On an empirical level, there is a body of evidence that suggests possible positive correlation between FDI and economic growth (Brock, Urbonavicius, 2008). Yet, while much evidence indicates a one-way causality between FDI and growth, there are many indications that the causality may run both ways (Han. X. Vo, 2004). The need for external capital inflow to finance current account deficit or some short-term economic failures of developing countries can not be over-emphasized too.

In spite of numerous theoretical and empirical works in the field of FDI, there is a need to synthesize different positions and different estimates concerning FDI. This might be defined as a scientific novelty and significance of this paper.

Facing deep economic crisis and seeking effective ways of recovery, governments are supposed to be more attentive to economic and not political rationale in their decision-making. It gives scientists hope to be heard and motivation to move forward.

The object of the paper is foreign direct investment and its economic and welfare effects on a receiving country.

The aim of the paper is to present, systemize and critically evaluate different theoretical and empirical approaches to FDI; to provide systematic approach on its economic impact to the host economy.

The methods used are logical and comparative analysis of literature; synthesis and deduction; holistic and systematic approach.

This paper tries to contribute to the literature on FDI by summarizing both positive and negative aspects of incoming foreign capital to a host countries economic welfare.

Different approaches of estimating the effects of foreign direct investment to host economy

There are several concepts of foreign direct investment and several ways of estimating its economic impact on host countries.

One concept is that FDI is simply a particular form of capital flow across international boundaries. These flows give rise to a particular form of international assets for the home countries, specifically, the value of holdings in entities, controlled by a home country resident (Auruskeviciene, Salciuviene, Vanage, 2008).

The other concept of direct investment is that it is a set of economic activities or operations carried out in a host country by firms controlled in some other (core) country (Lipsey, 2002, Buoziute et al, 2009).

Some authors (Lipsey, Purvis & Courant, 1994; Krugman, Obstfeld, 1997, Ciburiene, Zaharieva, 2006) argue that a distinctive feature of foreign direct investment is that it often involves not only acquisition of economic but also a political control. In some cases the extension of control is the essential purpose of incoming foreign capital. This implicates a necessity to screen foreign investments on economic as well as political grounds.

Economic theory provides conflicting predictions concerning the effects of direct foreign investments. There are scientists and schools, mainly representatives of liberal and neo- liberal approach, who advocate free economic run and implicitly free flow of capital. This point of view was on its highest in the middle of the twentieth century and proved to be proved to be dangerous and crisis- enhancing in the first decade of the twenty-first one.

 Plenty of empirical studies (most of them carried out in the late nineties) proved that on a firm level free FDI flow does not boost economic growth in a home country (Carkovic, Levin, 2002).

According to the dependency school, in the long- run, FDI tends to impede economic growth and development of recipient economies. Nevertheless, when constructing recovery plans after the recent crisis, politicians in highly- developed countries tend to ease restrictions on FDI and those in less developed countries- even to attract a foreign direct investment (Cirulyte, 2003).

And so it seems convenient to look deeper into the world practice by measuring the effects of FDI and stress the mainlines.

Pro- FDI scientists and policy makers have a number of arguments when praising foreign direct investment. They argue that incoming foreign capital ensures economic efficiency firstly, via new jobs created, secondly, via enabled technology transfer; thirdly, via encouraged competition in domestic markets; fourthly, via human capital development as foreigners engage (more) in employee training. Good example of positive FDI could be an “Ikea” case in Lithuania when incoming foreign MNE opened worldwide distribution channels to our furniture producers.

Lipsey (2002) states that the main positive outcomes of foreign investors occur if:

1) foreign – owned firms pay higher wages than domestically- owned ones;
2) they increase home country productivity;
3) foreigners introduce new industries.

According to Lipsey, foreign- owned firms may pay more because they often tend to be in higher wage sectors of the economy; because they tend to hire more educated and better – qualified workers than domestic firms; because they try to reduce worker turnover; because they have bought some proprietary technology and wish to reduce speed with which it leaks out to domestic rivals; because of their limited understanding of local labour markets etc.

On the other hand, it happens more often that foreign- owned firms pay less or the same as locals just because they can do so; or because the quantity of free labour-force exceeds for several times the jobs offered (Kazlauskaite, Buciuiane, 2008).

The evidence of spillovers of superior foreign productivity to domestically- owned firms is divided. Mixed story of possible spillovers to locals combined with
strong evidence of superior productivity in foreign-owned firms, suggests that overall host country’s productivity might be increased as a result of incoming FDI (Lipsey, 2002). However, most firm-level empirical studies of particular countries frequently do not find these positive spillovers from foreign-owned to domestic-owned firms (Aitken and Harrison, 1999, Ginevicius, 2009).

Positive effects of FDI are that profits from corporate taxes may be used to encourage host country’s development while investing in infrastructure for example; incoming FDI might be limited ability of host government to implement bad policies; sometimes the investment from a core country encourages domestic investment as well. FDI brings in financial resources which are scarce in a receiving country; and sometimes FDI really creates new jobs, spreads new technologies, knowledge and good production practice. FDI might increase exports and countries economic efficiency as well. However, many economists have reasonable doubts whether it happens every time in every country.

One more argument is often used in favour of foreign direct investment, namely that FDI has an advantage over other investment forms (portfolio or loans) as it proved to be more resilient in the times of economic crisis (Martinkus, Lukasevicius, 2008). Nevertheless during recent crisis some large transnational companies (TNCs), for example American car producers who were broadly settled in European Union (Spain, Poland, England), closed their European factories paying little attention on huge negative economic and social distortions left after such actions.

On an empirical level, there is a body of evidence that suggests possible positive correlation between FDI and economic growth in developing countries (Saboniene, 2009). Yet, while much evidence indicates a one-way causality between FDI and growth, there are many indications that the causality may run both ways (Han. X. Vo, 2004).

Benefits brought by some foreign investment in one country does not necessary mean that the same will happen in another one. Actions that proved to be efficient in Eastern Europe may fail in North Africa; methods that gave positive effects in North Africa might prove as unsuitable when investing in China.

According to Han X. Vo (2004), the evidence also appears to suggest that FDI is favourable to economic welfare only if appropriate conditions exist in the host economy. This includes such factors as adequate absorptive capacity and human capital, a capacity of domestic businesses to face and hold out foreign competition, abundance of projects and market gaps that cannot be filled up by home producers.

Blomstrom (2002) proved that increasing FDI may generate negative externalities in the form of distortionary cost rather then benefit of enhancing financial stability.

Many studies including that from Haussman et al. (2000) review the conventional wisdom that FDI tends to be higher in the countries that are safer, more promising and with better institutions and policies. They proved the contrary: FDI in total flows tend to be higher in countries that are riskier, more distant, resource rich, financially underdeveloped, institutionally weak and with a week currency.

Not all types of FDI equally contribute to the development of local economy. As it is stated in World Investment Report 1999, “greenfield investment are likely to encourage development most while mergers and acquisitions (M&A), that entail a simple change of ownership can be of dubious value”. The same idea is underlined in the works of Xan. X. Wo (2004), Loungani & Razin (2001), Snieska (2008) and many other authors. Unfortunately, time when greenfield investment was a major form of foreign direct investment is in the past, at least in Europe. In the last two decades more and more FDI has taken a form of mergers and acquisitions of domestically owned firms by foreign-owned firms. Investors, who will come to the countries slammed the hardest by recession for sure will be those who will buy troubled domestic companies at low prices instead of making some greenfield investment.

Benefits of FDI depend strongly on the incoming company too. Positive externalities brought in one country by one investor does not necessary mean that efforts of other investor in the same country will be equally successful. The real goals, the attitude, the experience of foreign investors are crucial when predicting possible effects of FDI. Moreover, financial sources of private investors must be considered too.

Economic and welfare effects of FDI depend both on an investor and on a receiving country.

Analyzing one by one pro-FDI arguments we can give more than one contra argument too. Increased competition may be beneficial for the host economy, and may not. Coming international corporations may push out emerging businesses if they are yet not able to compete. In that case many jobs might be lost instead of creating. According to Loungani & Razin (2001), Bernatonyte (2009) and Snieska (2008), in such situations government protection is needed. An argument for protecting infant domestic industries is recognized by many authors (Krugman, Obstfeld, 1996, Lipsey, Purvis & Courant, 1994). Nature protection or protection of cultural heritage can serve as more-up-to date argument for more cautious view to incoming FDI.

Multinational firms (MNE’s), while they often serve as vehicles for international borrowing and lending, primary exist as ways of extending control over their activities (Krugman, Obstfeld, 1996). The argument proved to be valid indeed in a never-ending privatization story of Lithuanian largest oil-refining company Mažeikių Nafta. Instead of making price based decision, the government was ready to give company away (at a price equal to a gift) to American company Williams just to escape Russian investors (Lukoil and Yukos in particular). Williams took the present gracefully and sold it to Yukos charging real market price and pocketing difference that was larger than investment.

Just one page above we have had an argument that in short-term FDI is more stable compared with other types of
investment. The following was apparent during Mexico crisis and Latin American debt crisis of 1980 (Loungani, Razin, 2001). On the other hand, during recent crisis some large transnational companies (American car producers in particular) who were broadly settled in European Union closed their European factories paying little attention to huge negative economic and social distortions that were left behind them. Once again- one size does not fit all.

Concerning the argument that incoming FDI can limit ability of local government to implement bad policies the causality may perfectly run both ways. Foreign flow of capital might spread good practices of corporate governance, accounting rules, and legal traditions. On the other hand, incoming FDI might result in encouraging host government to implement bad policies.

When attracting FDI governments use tax cuts, subsidies and many other means. When deciding to slow down the volume of incoming foreign capital governments most commonly use institutional barriers of FDI: ownership restrictions, rate of return restrictions, project approval requirements, trade and financial restrictions etc. Countries not clearly understanding the effects that foreign capital can bring to their economies sometimes engage in such kind of actions which ultimately can hamper growth. Epstein (1999) claims that countries trying to attract investment by subsidies and tax breaks can lead to substantial reduction of government revenues which could otherwise be used to invest in education and infrastructure what ultimately creates attractive environment to FDI itself, fastens economic growth and increases total welfare. Such environment may be even more important than tax breaks.

Often it is difficult for developing countries governments to manage foreign investment to their advantage as there is a large asymmetry in bargaining power between core countries investors on the one hand and host governments - especially those from countries that are poor, lack scarce natural resources and/or small - on the other (Han X.Wo, 2004).

Xan X.Wo (2004) represents the principles of so-called "dependency" school that can not be left aside. The position is that FDI benefits the core industrial economies at the expense of the peripheral underdeveloped countries. As a result FDI can be contributing to increasing world inequality instead of giving positive externalities of FDI. Representatives of "dependency" school argue that in a long- run, FDI tends to impede economic growth and development of recipient economies. Although underdeveloped countries lack capital and industrial technology, they often are rich in natural resources and/or inexpensive labour. While income or wealth is created in expensive labour. While income or wealth is created in expensive labour. While income or wealth is created in employee training, FDI tend to use well- educated local workers.

FDI has an advantage over other investment forms (portfolio or loans) as it proved to be more resilient in times of economic crisis. Investors, who will come to the countries slammed the hardest by recession for sure will be those who will buy troubled domestic companies at low prices instead of making some greenfield investment. FDI in form of mergers and acquisitions (M&A), that entail a simple change of ownership can be of dubious value.

The effects of FDI

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<tr>
<th>Theory- based pro- FDI arguments</th>
<th>Contra- FDI arguments based on empirical studies</th>
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<tr>
<td>Incoming foreign capital ensures economic efficiency</td>
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<td>FDI create new jobs</td>
<td>If incoming FDI causes closure of local firms, jobs might be lost instead of creating.</td>
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<td>Foreign firms pay more because they tend to hire more educated and better – qualified workers; because they try to reduce worker turnover; because they have bought some proprietary technology and wish to reduce speed with which it leaks out to domestic rivals; because of their limited understanding of local labour markets etc.</td>
<td>It happens more often that foreign-owned firms pay less or the same as locals just because they can do so; or because the quantity of free labour-force exceeds the jobs offered several times</td>
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<tr>
<td>FDI enable technology transfer</td>
<td>FDI does not enable technology transfer because of commercial secrecy.</td>
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<tr>
<td>FDI brings positive economic effects coming from encouraged competition in domestic markets</td>
<td>Coming international corporations may push out emerging businesses if they are not yet able to compete.</td>
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<tr>
<td>FDI enables human capital development as foreigners engage (more) in employee training</td>
<td>FDI can use well- educated local workers to increase their profits.</td>
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<td>Profits from corporate taxes may be used to encourage host country’s development while investing in sectors with high economic potential</td>
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<td>FDI might increase exports</td>
<td>Often it is difficult for developing countries governments to manage foreign investment to their advantage as there is a large asymmetry in bargaining power</td>
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<td>Sometimes the investment from a core country encourages domestic investment as well.</td>
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<td>So-called greenfield investment are likely to encourage development</td>
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<td>FDI has an advantage over</td>
<td>During last economic decline lots off</td>
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As it was mentioned above, the pro-FDI scientists and policy makers have a number of arguments when praising foreign direct investment. So do the scientists, who provide critical approach to this venue. Convincing argument for being more cautious when attracting FDI might be that negative aspects of FDI are based on an empirical when pro-FDI statements mainly on a theoretical approach.

Wide-spectrum economic analysis can help make sense of the politics of recovery policy. And even if we are more liberals than Keynesians, economic rationale suggest that developing countries or those who are on their path to recovery need to be strategic and more calculative inviting multinational competitors to operate side by side with home industry.

Last but not least-most scientists agree on the statement that governments should focus on improving the investment climate for all kinds of capital, domestic as well as foreign (Epstein, 1999, Loungani, Razin, 2001, Blomstrom, 2002). Effective investment packages should be part of countries industrial policy and be available on equal terms to all investors.

Conclusions

1. Economic theory provides conflicting predictions concerning the effects of direct foreign investments.
2. Pro-FDI scientists argue that foreign investments may produce some positive externalities for host countries in the form of higher employment rates, higher wages, technology transfers, increased production and productivity and raising export.
3. Theory of FDI states that positive effect of FDI might be that it brings in financial resources which are scarce in a receiving country and by doing so helps for receiver to move forward from a stagnant economic position.
4. Plenty of empirical studies proved that in the reality picture often is different: increasing FDI may generate negative externalities in the form of distortiatory cost rather than benefit of enhancing financial stability (Blomstrom, 2002); instead of increasing, foreign investors can reduce employment by dismissing local workers or by crowding out local businesses that cannot compete with multinationals; positive capital flows often turn to negative if investors use cheap local raw materials and resources and sell expensive final goods; positive capital flows also often turn to negative if investors acquire defaulting local firms with high future profitability.
5. Most firm-level empirical studies of particular countries frequently do not find positive spillovers from foreign-owned to domestic-owned firms (Manning, Shea, 1989, Razin, Sadka, 2003); empirical studies also show that on a firm level free FDI flow does not boost economic growth in a home country.
7. Rather than giving away the ‘candy store’ in the form of subsidies and tax breaks, developing country governments should mobilize resources for infrastructure and labour resources that will complement the economic structures and needs of the particular developing country.
8. The investment incentives focusing mainly on foreign firms are not a recommendable strategy. Rather than proposing narrowly defined FDI policies, attractive terms to investors should be seen as part of a country’s overall industrial policy and be available on equal terms to all investors, foreign as well as domestic.

References


Tiesioginės užsieno investicijos: gelbėjimosi ratas ar ekonominio augimo trūkdis?

Santrauka

Tiesioginio asta Žilinskio 524

Tiesioginio investicijų (TUI) pritraukimas besivystančių šalių vyriausybų neretai yra vertinamas kaip vienas iš esminių šėkmingo ekonominio augimo veiksnių. Išsivysčiusių šalių ekonominės politikos formuotojai laikosi dualistinei pozicijos: besivystančių šalių vyriausybės ragindamos kuo plačiau atverčia rinkas užsienio investicijoms, vidaus rinkoje ima visai teisingai įmonių priemonių, kad būtų galima riboti kitų šalių įmonių atėjimą ir įsivystimą joje. Ir jie galbūt yra teisingi.

Ekonominės teorijos pateiktos pakankamai prieštaravusios nuomonės apie tiesioginės užsieno investicijų ekonominį poveikį į priimamčią šalį. Mokslininkai ir mokyklos, vadovaujant liberali, pasiako prieš bet kokius laisvo kapitalo judėjimo apribojimus. Keininsės mokyklos pasekėja teigia, kad šalies ekonomikos virkme turi pasireikšti visuotinės valstybės vaidmuo; keininsė ižvelgia nemažai negrįžtų rūkų atvejui užsienio investuotojų aspektų.

Todėl yra tai, kad kritinis (arba realistinis) požiūris į tiesiogines užsieno investicijas yra grindžiamas empirinių stebėjimais, tikėtųvisai tikrinant teorines tiesas.

Ekonominis sunkmelis politikos verčia imtis neatidėliotinų stabilizavimo ir križių įveikimo veiksnių. Apmaudu, bet dėl valdžioje esančių asmenų kompetencijos stokos neretai imtis pradžios, dėl neigiamų kompetencijos stokos norimas tikslas nebūna minėtų mokslininkų atsiprašymas. Šio straipsnio tikslas yra išanalizuoti, susisteminti ir vertinti teorines tiesiogines ir praktines tiesias užsienio investicijų poveikio į priimamčią šalį, teikiant aptikimą situacijos vertinimui. Ekonominėje literatūroje užsienio investicijų intos navicos einant į priekį įprastai minėtų teorinių atnaujinimų paradokso. To meto mokslininkai įsitikinę, kad nepradėjus į priekį tiesioginių korporacijų kūrimeni beveik neturėtų įtakos įvairiausių makroekonominių aspektų, iš dalies, įvertinant šios teorijos praktinės vertės, galima teigti, kad šalies įmonių investicijos visuomet užsieniečių kapitalo galimas plėtotės veiksnys, kurį galima išnaudoti įvairioms tikslams.