

Keynote Speech

FDI and Growth for Developing Countries: MNEs and the Challenges of the “New” Economy

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Introduction

In the context of the theme of Round Table 5, this paper in dealing with Foreign Direct Investment (FDI) and economic growth will acknowledge that there is a substantial body of theoretical and empirical research in the discipline. This stock of literature is considerably weighted in the perspective that addresses the international dimensions of business and corporate strategy as well as organizational behaviour. Econometric perspectives are also widely available. However, in speaking to this paper, the academic and research literature on international business that captures the essential dynamics of FDI and multinational enterprises (MNEs) will not be surveyed.¹ The determinants of FDI will be briefly touched upon, without going into academic detail, but the main thrust of the paper is in the direction of the inter-relation between FDI and MNEs in the new setting of the international location of production – and their implications for the investment policies of developing countries. The thorny issue of the place of incentives in FDI regulatory frameworks is not addressed directly or extensively for good reason – empirical research illustrates amply that in general incentives are not highly prioritized in the considerations or motivations when MNEs make their economic analyses for FDI. However, once an investment has been made, naturally MNEs will take advantage of whatever incentives there are in order to reduce operational or transactions costs. Having said this, the paper does make some remarks about the role of incentives.

Overview of FDI

There are many major issues regarding the juxtaposition of globalization, the role of FDI and MNEs in development and the reality of “failed” or “failing” states, which demonstrate an apparently endemic failure of parts of the global economy to rise above subsistence levels onto the path of robust industrialization.² Among the most pressing are the challenges and opportunities concerning FDI for developing countries. Some of these challenges and opportunities are faced by MNEs as well, and they provide points to which developing countries and economies in transition can move to minimize their disadvantages and maximize their advantages in strategizing the role of FDI and MNEs in their industrial development. MNEs and FDI are the key actors on the global economic stage, and the essential features of the international operations of MNEs are of crucial importance for the developing countries to appreciate and fully comprehend if they are not be sidelined in the race for development.

Foreign Direct Investment – production owned and operated across international borders by foreigners – evokes international business in terms of real capital flows recorded as an identity in balance of payments statements.³ However, given the evolution of the modes of internationalization

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- 1 Multinational enterprises are taken to include all types of foreign investors notwithstanding differentials in size and geographical coverage.
- 2 Primarily the developing countries which are taken to include the least developed countries as well as the economies in transition.
- 3 Foreign direct investment aggregates corporate economic activity as a component of the financial account of a country recorded in the balance of payments. Its components are: (1) the net acquisition of share and loan

by MNEs since 1960, FDI operations actually may involve neither cross-border capital flows nor investment in capacity. This is because financing can be conducted through host capital markets and, in the case of mergers and acquisitions, there may not be an increase in capital expenditure to increase output. Nevertheless, from a variety of sources,⁴ recorded FDI flows demonstrate a remarkable global growth profile, from under US\$ 60 billion in 1980 to just over US\$ 1,400 billion in 2000 before falling back to an estimated US\$ 490 billion in 2002 (OECD 2003). The distribution of FDI shows significant growth in flows to developing countries, from just below US\$ 50 billion in 1990 to just below US\$ 200 billion in 2001 (UNCTAD 2002).

An overview of the global distribution of FDI shows that developed countries have maintained the lion's share since 1980. This share has fluctuated between 70 per cent and 90 per cent with a few exceptional years (notwithstanding the relatively low performance of 56 per cent in 1982 and the high performance of 90 per cent in 1987). In general, African, West Asian and Eastern European countries have performed poorly in comparison with South and East Asia and Latin American countries. The main beneficiaries of FDI flows to Asia have been the countries of South and East Asia, particularly "greater" China, Singapore and Malaysia. In Latin America, the high performers have been Brazil, Mexico, Argentina and Chile. The flows to Africa, and particularly to sub-Saharan Africa, have been disappointingly low – almost to the point of immeasurability – with the bulk of the low volumes being captured by Nigeria and Angola in the south and by Egypt and Tunisia in the north (UNCTAD 2000). This, however, does not mean that the continent is incapable of connecting industrially with the world economy (UNIDO 2000).

The vectors of FDI and globalization

Since about the early 1980s, two major trend developments have influenced profoundly the industrial organization of MNEs and the profile of increases in FDI activity. The first – state directed – is the continuing percolation and reach of policy liberalization under pressure from multilateral trade negotiations and agreements, as well as the conditionalities of structural adjustment programmes supported by the international financial institutions. These have been reinforced by the intensive competition – company induced – between countries focused on capturing the beneficial impacts of FDI from MNEs (Oman 2000). Evidence of liberalization in policy regimes and regulatory frameworks for FDI is provided by the number of recent pro-FDI changes that various countries have undertaken.⁵ Policy liberalization has led to decreasing transaction costs in cross-border FDI and trade. The response, in terms of industrial organization of international firms, is manifest in the acceleration, and geographical spread, of spatially distributed networks for international production and servicing (UNCTAD 1993, 2001).

The second major trend development – company directed – is the spatial location and dynamic distribution of manufacturing and services, in both "horizontal" and "vertical" FDI (Dicken 2003) within industrialized, and across developing, countries and especially in the so-called emerging markets of Central and Eastern Europe, Latin America and Southeast Asia. This spatial distribution, driven in large part by MNEs' competitive search for efficiency gains and market share in response to increasing production costs and the perils of exogenous shocks,⁶ is characterized by the strategic

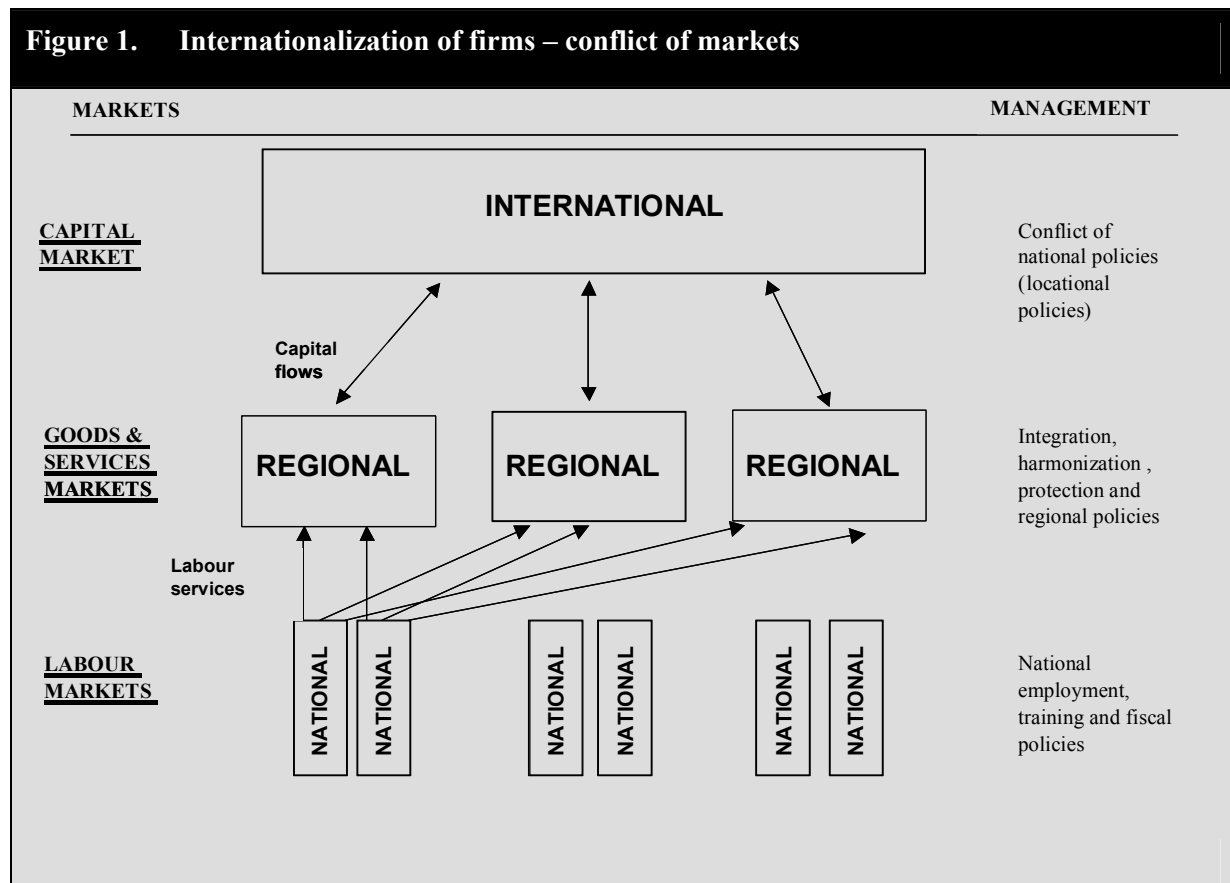
capital through mergers and acquisitions or takeovers, joint ventures, and the establishment of new green-field subsidiary companies; (2) profits of overseas subsidiaries which are reinvested abroad and (3) parent to subsidiary capital transfers.

4 IMF, *International Financial Statistics*; OECD, *International Direct Investment Statistics*; UNIDO; and UNCTAD, *FDI/TNC Database*.

5 In 1991, 35 countries introduced 82 changes in their FDI regimes, compared with 71 countries making 208 changes in 2001. In 1991, 97.6 per cent of all changes made were pro-FDI, compared to 93.3 per cent in 2001; down from 98 per cent in 2000. Asia and the Pacific region introduced the highest number of pro-FDI changes.

6 Such as episodic financial crises and the oil price shocks of 1973/74 and 1979/81.

integration of MNE headquarters and affiliates and is articulated through specific operational mandates for particular subsidiaries (Birkinshaw & Hood 1998). With respect to Southeast Asia, where this strategic integration of MNE headquarters, subsidiaries and affiliates is arguably most visible and efficiently staged, the spatial distribution has quite distinctive trade features that are exemplified by vertical intra-industry trade (VIIT) and international exports in a relatively narrow range of product categories.⁷ The regional dimension to this spatial distribution should not be overlooked (Figure 1).



Despite the nuances in the theoretical literature on FDI, growth and economic development since the 1960s, and the empirical debate over the derived net benefits of globalization (Fischer 2003; Stiglitz 2002), given the weight of evidence there is a robust argument that international business – manifest as FDI – is positively correlated with economic growth and the integration of world markets (Albuquerque et al. 2002). This growth is visible, through the positive externalities generated and captured by hosts to FDI, in terms of increased intermediation by some developing countries with the Triad-dominated international system of the FDI-intensive geographical distribution of production.⁸ This correlation is no longer a subject of debate. However, the magnitude of the effects at firm,

7 In the electrical machinery industry, the share of VIIT in total trade in East Asia grew from 31 per cent in 1996 to 43 per cent in 2000. With respect to the share of Japan's total trade with the electrical machinery industry in the five main Southeast Asian economies, the respective figures for 1988 and 2000 are as follows: Indonesia 2 per cent to 39 per cent; Malaysia 40 per cent to 34 per cent; Philippines 16 per cent to 55 per cent; Singapore 17 per cent to 43 per cent; and Thailand 16.5 per cent to 41 per cent (Fukao et al. 2003).

8 The Triad is taken as the geo-economic spaces of North America (and its NAFTA dimension), the European Union (recently enlarged) and the Japanese sphere of economic influence in Asia.

industrial sector or sub-sector, industry, and economy-wide levels – longitudinally and cross-sectionally – is subject to continuing empirical research and discussion (Ewe-Ghee Lim 2001).

The central issue remains how to address, in a more balanced manner in favour of the developing countries (notwithstanding the, for some, disappointing outcome of the multilateral trade negotiations in Cancun, Mexico, in September 2003), the widening asymmetries in FDI flows and stocks. Since the 1960s, MNEs – the principal actors in the dynamics of FDI – have been increasing their capacity for managerial co-ordination of, and capability for control over, international production and its articulated spatial distribution. How developing countries, through anticipatory policy postures and adaptive structures of incentives, manage to insert their economies (and inherently their industrial sectors and enterprises) more solidly into the interstices of global value-chains and co-ordinated networks of MNEs remains the central conundrum. Clearly, some developing countries are doing well at this new game; others are faring poorly.

The previous separated patterns of FDI and international involvement by firms (usually sequential and, hitherto, more predictable in terms of the mode of entry) have been superseded by the multifaceted pattern of “alliance capitalism” (Dunning 1997) hallmarked by MNEs’ competitiveness. This, in turn, is characterized by FDI involving simultaneous collaboration with competitors and rivalry (in different economic spaces) with strategic and alliance partners, as well as participation in dense networks of technology suppliers (Buckley & Casson 1976, 2003). The intricacies of these internationally networked systems of industrial sourcing, technology, production, marketing and servicing place severe challenges on economic, industrial and development policy-making in developing countries. The essence of the challenges is best seen as a puzzle of what economic and industrial policies to adopt on the one hand, and how to sequence policy instruments in a manner that captures the desired components of the MNEs’ network on the other hand. The performance of Southeast Asian economies, since the 1960s but particularly over the last two decades, elucidated in part by the 1993 World Bank study *The East Asia Miracle: Economic Growth and Public Policy* (World Bank 1993), highlights the essential role of government in overcoming market failures and assisting economic development. That performance also demonstrates what is possible for other developing countries.

Among the challenges for developing countries not sufficiently well-versed in the lessons from Southeast Asia is how to emulate, and compress into a shorter time, that kind of performance while coping with the triple confrontation of: a “rules-based” world trading system; technological “componentization” (the slicing up of the stages of production and its spatial distribution); and the emergence of China as the “workshop of the world” (Roberts & Kynge 2003, p. 13).

The challenge of FDI in the new economy for developing countries: What lessons?

The political-economy of cross-border transactions in FDI and trade within the “new economy”,⁹ and its impact on the configuration of MNEs’ decision-making structures with reference to headquarters-subsidiary mandates, has resulted in crucial changes in strategic thinking within MNEs. This carries serious consequence for the world economy in general and the developing countries in particular.

The so-called “golden age of capitalism” in which MNEs were predictably structured with divisions locked into rigid linkages with other parts of the *same* firm has given way to a new international environment that is very different, and very challenging from a policy perspective. With competitive pressures increasing relentlessly, the questions asked by MNEs are twofold:

- Firstly, where to locate productive assets and manufacturing activity in a manner that efficiently differentiates between locations and maximizes the difference between manufacturing value-added and locational cost structures; and

9 The “new” economy is taken as the technological revolution in information and communications and electronic commerce in the context of developments in the opening years of the new millennium.

- Secondly, how should the assets and activity be controlled (and co-ordinated)?

The locational decision concerns the relative merits of the cost and market-related advantages between different locations. The control decision concerns whether or not to own or to have *an option* on ownership (Trigeorgis 1996) through collaboration (for example through outsourcing, sub-contracting, joint ventures, or strategic alliances with different firms). In the new economic environment, the MNEs' desire for flexibility militates against the rigid backward and forward vertical integration into input factors or into distribution of the "golden age". The more advantageous alternative is to sub-contract production and franchise sales (thereby distributing the associated risk profiles). The implications for developing countries are that their leaderships need to fully understand, and incorporate into their development policy and strategy, the dynamics of these two decisions by MNEs.

The outcome of these two decisions by MNEs is manifest as disintermediation and re-intermediation of the spatially distributed production networks and the internalization of external markets by MNEs. With managerial utility being emphasized ever-increasingly, especially during the 1990s, divisional managers have incentives to want to have more degrees of freedom in which they can deal with economic agents external to their own firm. The overall result of this dynamic is a very complex strategic set that confronts decision-makers and managers in MNEs (and of course, by definition, policy-makers in developing countries who aspire to capture parts of the MNEs' system of production and marketing). It is evident that, in the course of the four "development decades" (notwithstanding the "fortune" of the Vietnam War,¹⁰ and the inflationary 1970s and early 1980s), policy-makers in Southeast Asia have been arguably the best at understanding how exploitation of these dynamics can be built into economic development strategies.

In examining the new economy, it needs to be noted that approximately 80 per cent of all e-commerce transactions is accounted for by B-2-B engagements over the inter- and intra-net. In other words, it is interactions between formal businesses that are driving the content in, and the media of, e-commerce. This has profound implications for developing countries that wish to connect with the integrated international production and marketing services of MNEs, their networks of subsidiaries and the supply chains that link them to other firms. Among the most serious implications is that the perennial dichotomy between focusing on "the global" or "the local" in co-ordinating networks can be better managed on the world-wide web and/or the intranets of MNEs. Clearly, the implications are simply enormous for developing countries "on the wrong side" of the digital divide.

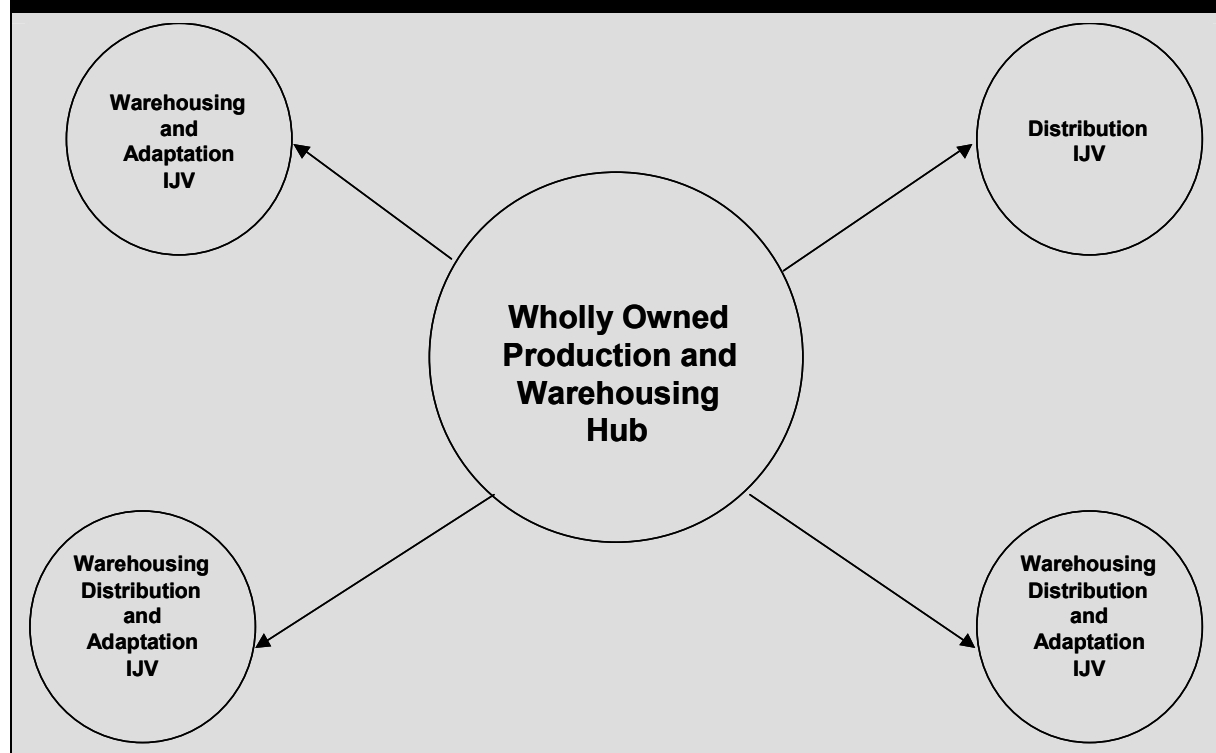
The outcomes of this process of co-ordinating networks with reference to the MNEs' operations underway in the world economy include the fact that the internal markets of MNEs are tending to become more "open" and less "closed". Opening up the internal markets of MNEs leads to a loosening of the ties between divisions and their production capacities at adjacent stages of manufacturing. The effect is that MNEs become more like "hubs" in networks of interlocking collaborations (Buckley and Casson 1988, 1996), as shown in Figure 2. The opened up internal markets of these networks are more efficient in providing price and profit signals to which all players, including policy-makers in developing countries who proactively incentivize their industrial sectors, must respond competitively. This is why the so-called digital divide – in reality a profound difference in capacity and usage of information communications technologies (ICT) between the industrialized and the developing countries – is so crucial.¹¹ The lack of capacity and low skills in usage debilitate the developing countries from exploiting the interstitial spaces of spatially distributed networks of the MNEs.

10 The volume of resources poured into Southeast Asia during the period for the "effort" would need to be recalled.

11 Developing countries' capacity is highly truncated. It is estimated that the total number of telephone lines in the 48 least developed countries (LDCs) is less than one per cent of the number of lines in North America, and that Africa has about 1 per cent of all the world's telephone lines (and of these South Africa has about half).

Such hub-centred networks retain torsional flexibility across a broad range of corporate functions, including industrial as well as science and technology research and development (R&D). To a certain extent, the high-performance Asian economies (the Asian “Tigers”) and the newly industrializing economies of Asia and Latin America testify to the successes of diffusion of technology since the first development decade of the 1960s. Thus the range of countries able to innovate with confidence and competence has increased significantly. However, many developing countries have failed to exploit this development adequately with the result that there is not only a digital divide but also an innovation divide.¹²

Figure 2. “Hub and Spoke” strategies: An example



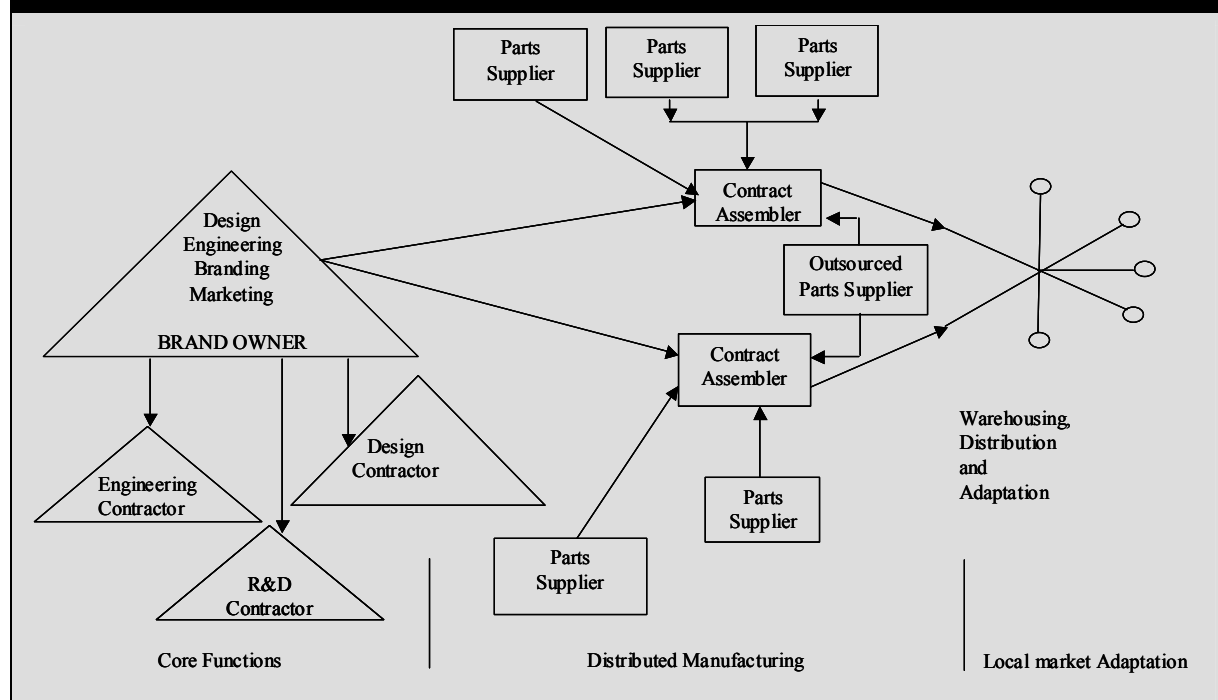
The new economic perspective for MNEs in managing the international operations of their FDI concentrates managerial attention on: The characteristics of volatility and uncertainty in markets; the value of options and flexibility in entry modes for FDI; alliances, collaborative and network forms of co-operation and competition; entrepreneurship within networks; managerial competence; and a corporate and organizational culture that is progressively more adaptable to the demands of change. This set of valuable attributes that management in organizations engaged in international business must continuously develop distills into flexibility of operations. This is the ability to orchestrate the allocation, and re-allocation, of resources efficiently, smoothly and rapidly in anticipation of, and response to, change. Implicit in this is the ability to locate (and capture) resources, that may not be within the purview of the organization, also smoothly and quickly in response to internal or customer demands. The greater the amplitude and frequency of change in the business environment, the greater this need for organizational and operational flexibility (Figure 3).¹³

¹² These of course reflect the asymmetries in FDI flows and technology flows.

¹³ This raises questions pertinent to ‘emergence’ – the study of complex adaptive human systems and businesses from the perspective of complexity science and philosophy – and coherence in strategy and operations of MNEs of which developing countries need to be increasingly aware.

The challenge for the developing countries is that the evidently increasing pace in the liberalization of FDI, trade, and capital and financial markets as well as the agglomeration of factor markets (since the collapse of the Bretton Woods-based system of fixed exchange rates in the early 1970s) means that exogenous shocks travel through geo-economic spaces without the once-present “breaks” imposed by sovereign borders, each with differentiated set of rules and regulations at a pace that catches most policy-makers in developing countries by surprise. Developing countries need to appreciate the examples of punctuated equilibria much more intensely if they are to emerge from the marginalization that is confining them. The result of the centre-periphery quality to the structure of MNEs and that sources of innovation are no longer confined to MNEs’ headquarters (Casson et al. 1991) is an increasing aversion to internal monopoly.¹⁴ The underlying common factor to this dynamic is the acceptance among international managers, as they operationalize their FDI, that the boundaries of the firm are no longer well-defined and are far more “virtual” than real. The notion of arm’s length markets is less solid and firms merge with markets and markets merge with firms.¹⁵

Figure 3. Globally distributed operations



The analysis indicated above raises the issue of accelerated dynamic market entry and exit as the strategic preference for MNEs. In the new volatility, FDI is revealed as a high risk strategy – in the absence of location specific compensating factors such as a transparent and coherent business climate with both the “hard” and “soft” infrastructure to do business. However, developing countries would need to realize that FDI offers much better options for capturing information in comparison with other

14 In the 1980s, the arguments for maintaining centralized R&D lost ground to those managers wanting to distribute these centers as services for internal (and in some cases of co-R&D joint ventures external) customers in competition with other providers (universities etc.) in an attempt to diversify risk. There followed the delayering of middle management ranks.

15 According to UNCTAD (1995), 60 to 70 per cent of all global trade is conducted either *within* MNEs or *between* MNEs.

entry modes.¹⁶ Although exporting and licensing confer more flexibility in anticipation of market decline, FDI confers more flexibility in anticipation of market growth.

What options are there for an even more flexible approach for MNEs? Kogut (1991) posits that international joint ventures (IJVs) may be the answer as they hold the value of options.¹⁷ In terms of strategic superiority, on the one hand, an IJV in which the real option is never executed is probably inferior to an FDI that takes the form of a wholly-owned subsidiary; on the other hand, an IJV in which the option is exercised at the first opportunity does not last long (by definition).¹⁸ With respect to the interaction between markets that developing countries have to take into consideration when designing their FDI policies, it is worth noting that, from the MNEs' perspective,¹⁹ that the cost-based competitiveness inherent in the economies of scale and rationalization in networked global operations have to be weighed against the revenue-based competitiveness of local operations due to the fact that, in the latter case, MNEs can differentiate products and services to such an extent as to extract maximum rents from their firm or ownership specific advantages (Dunning 1977, 1988, 2000). In much the same way, reflecting the flexibility inherent in spatially distributed production networks, the "hub" and "spoke" strategies employed by MNEs enable responsiveness to market decline by divesting distributional assets to local partners (exercising one of the options in joint venturing) while retaining production capacities with high appropriabilities (Lall and Streeten 1977),²⁰ the output of which can be diverted to other markets.

Globalization represents a dynamic that is geared to different speeds depending on geography. The concern over the marginalized developing countries is that their collective velocity is so retarded. They are in danger of getting left completely behind in a world of their own that is essentially cut off from the industrialized countries and characterized by extremes of high risk, the uncertainties of the "failed state", and the inability to use either the language of modern business or the tools of communication in effective engagement with the rest of the world. The electronic revolution has increased the co-ordination skills of MNEs. Thus the intensification of the process underway whereby the collation of data, which when given purpose leads to information; and which in turn when given value, through manipulations such as statistics, yields knowledge, is largely by-passing many of the developing countries. The information processing and co-ordination skills of MNEs give flexibility by improving forecasts and reducing the costs of change with respect to the location of international production. Developing countries have to begin cultivating the zeal for data and its purposeful exploitation and manipulation so that policy-makers can anticipate more accurately the moves and counter-moves of MNEs.

With respect to the co-ordinated networks in terms of outsourcing and related logistics, contract manufacturing (under various guises such as sub-contracting and original equipment manufacturing using formalities such as licensing and co-production) has been growing apace since the late 1980s and early 1990s as MNEs have sought to concentrate on value adding upstream activities while

16 Anecdotal evidence suggests that in many cases, MNEs prefer to maintain a presence in a market, even when there may be an economic argument for exit, for the advantage of being able to capture information and market intelligence.

17 The phenomenal growth in joint international business associations throughout the 1990s attests to this. In addition to mergers and acquisitions being responsible for most of FDI throughout the 1990s, according to *The Economist*, between 1996 and 1998 over 20,000 international strategic alliances (ISAs) were formed worldwide. The number of bio-technology ISAs for the leading pharmaceutical MNEs jumped from 152 in the period 1988-1990 to 375 in the 1997-1998 period. The number of inter-firm technology and marketing agreements rose from 280 during 1980-1993 to 650 in 1996 alone. ("Mergers and alliances: Hold my Hand", *The Economist*, 15 May 1999, pp. 75-76).

18 This explains the reluctance by managers to enter IJVs, the instability of joint ventures (Pearce 1997) as well as the pressing need for managers to enter into IJVs.

19 See London (2002, p. 15), for the management levers used by global companies.

20 Due to monopolistic-oligopolistic advantages that are sourced, *inter alia*, from technological functions.

shedding routinized downstream activities.²¹ From the developing countries' perspective, the issue is how to go about identifying the evolution of, and capturing the directions of change in, the sub-contracting networks of MNEs as they are configured and re-configured according the relative differences in factor conditions and costs among countries, and within regions? This difficult task of the developing countries is complicated by the fact that the sub-contracting networks of MNEs are also subject to intra-industry trade and FDI vectors (Fukao et al. 2003).

Concluding remarks

In the promotion of, and competition for, FDI, Africa stands in a field of its own where the flows are miniscule, with few exceptions (Tables 1 and 2). While the weight of evidence points to the argument that international business – manifest as FDI and its externalities – is positively correlated with economic growth, the ability to capture externalities depends very much on the absorptive and technological capacities available in the host countries, and therefore in the ability to grab “best practice”. The implicit assumption is that local firms must be able to absorb the spillovers from foreign investors – in other words the technology gap cannot be prohibitively large. These capacities do not seem to be either immediately visible or robust in developing countries, and Africa in general and the least developed countries (LDCs) in particular. When combined with the requirement of an enabling host investment climate in terms of whether the FDI reception regime is economically open with well-articulated policies that change in dynamic reflection of the changing strategies of MNEs (as is so visible from the Singaporean example), the challenges are indeed considerable. Hosts to FDI would need to move from a passive posture towards FDI to a more proactive policy stance whereby they calibrate and re-calibrate continually their investment regimes to progress to higher levels of modal neutrality, contestability for factor markets and policy coherence.²²

Table 1. FDI inflows in LDCs, 1991-2002 (US\$ million)

		1991-1996 (Annual average)	1997	1998	1999	2000	2001	2002
1	Least developed countries	7,713	3,401	4,573	4,974	3,427	5,629	5,232
2	All developing economies excluding China	66,061	148,987	147,533	188,976	205,285	162,585	109,445
3	1 as %2	2.59	2.28	3.10	2.63	1.67	3.46	4.78

Source: UNCTAD (2003), p. 252.

21 See “Factories for Hire”, *The Economist*, 12 February 2000, p. 81; and “Incredible Shrinking Plants”, *The Economist*, 23 February 2002, pp. 75-78, for a view of contract manufacturing growing at about 20 per cent per year since the mid- to late-1990s, with Asia and Mexico playing key roles and redefining, for example, the boundaries between automotive manufacturers and their suppliers through outsourced “flexible global manufacturing”.

22 Modal neutrality ascribes to investment policies the best ways to serve the markets in terms of entry mode. Contestability refers to the legal ability of foreign as well as domestic investors to compete for the same input factors of production. Policy coherence signifies the degree to which development objectives, the FDI regime and interpretation of that regime, in its regulatory form, has internal consistency across business functions, at different levels of Government and in different places in the country.

Table 2. FDI inward stocks in LDCs, 1980-2002 selected years (US\$ million)

		1980	1985	1990	1995	2000	2001	2002
1	Least developed countries	3,419	5,132	8,165	16,208	35,609	40,867	46,099
2	All developing economies excluding China	301,219	396,306	526,669	783,121	1,681,222	1,778,733	1,891,896
3	1 as %2	1.14	1.29	1.55	2.07	2.12	2.30	2.44

Source: UNCTAD (2003), p. 252.

It is not possible to refer to the dynamics of FDI, its policy regime and the promotion of FDI without reference to incentives and the difference they might make. First, it needs to be recalled that the empirical research indicates that incentives are low on the list of motivations of MNEs, especially when they are provided by developing countries. This is because the authorities making the various offers lack credibility, and in most cases the incentives, however generous they may seem, are not sustainable either over the lifetime of the investment or the strategic timeframe of MNEs. Nevertheless, it appears that “incentives-based competition for FDI is a global phenomenon” (Oman 2000, p. 8). Oman illustrates the two sides of the argument over incentives by reference first to the positive-sum game hypothesis. In this hypothesis competition for FDI, based on incentives oriented towards the “fundamentals” of the investment climate – those with public goods characteristics – ratchets up the respective quality of the environments of competing countries over the long-term. The other side of the argument is the negative-sum game hypothesis. In this hypothesis competition for FDI, using fiscal and financial incentives, results in the “prisoner’s dilemma” created by the dynamics of the competition (Oman 2000, p. 14), and “bidding wars” and the race to the bottom in the short-term.

Incentives also appear to appeal more to cost-minimizing “footloose” investors who may not necessarily be bringing high levels of investment or technology that a host country may want for its socio-economic development. These types of investors may also be prone to “shopping” around to engage in “an auction of incentives”. Empirical research suggests that incentives are perceived to be more important for export-oriented FDI in comparison with market seeking FDI. As a function of their advanced economies, developed countries are prone to offer non-fiscal incentives such as grants and subsidies. In contrast, due to their “stages of development”, governments of developing countries tend to offer fiscal incentives, typically tax holidays. In the final analysis, it is the coherent design and implementation of the incentives regime that matters rather than the question of incentives *per se*. Equally importantly, just as with other aspects of the FDI policy framework, the incentives have to be seen as “windows” of opportunity that open and close in order to coerce MNEs to make the kind of investments that developing countries wish for; bearing in mind the fierce competition for FDI. This said, MNEs now expect that the real incentive for investing in a country should be the overall quality of its investment climate, *ceteris paribus*, with the efficiency-seeking, market-seeking and raw materials-seeking motives of MNEs (Table 3).

Table 3. Time needed to establish a business

Top Five	
Australia	2
New Zealand	3
Canada	3
Denmark	4
USA	4

Source: World Bank, as quoted in *The Times*, 8 October 2003.

An important consideration is the cost to the host developing country of providing the type of “direct” incentives (those without a public goods dimension to them). These costs are seen in terms of fiscal revenue losses. In the case of developing countries, the complexities of incentives systems and the acknowledged administrative weaknesses and institutional incapacities, especially in sub-Saharan Africa, can severely deform the design and implementation of the incentives regime. The result is the proliferation of rent-seeking points in the FDI regime, the down-side risk of distortionary effects and the discrimination between groups of investors (Table 4).

Table 4. Time needed to establish a business

Top Five	
Angola* ⁺	146
Brazil	152
Mozambique* ⁺	153
Laos PDR*	198
DR Congo* ⁺	215

Notes: * Least Developed Country + Africa

Source: World Bank, as quoted in The Times, 8 October 2003.

In summary then, some of the lessons of FDI in the new economy for developing countries centre around the acceptance that, while market size in terms of the growth of disposable income remains a key motivation for FDI, the “fundamentals” of the investment climate and environment (including the provision of public goods) are becoming far more important for the majority of foreign investors. This is related to the increase in volatility in the global business environment and the need for MNEs to have flexible options for dynamic market entry and exit with respect to their spatially distributed network of affiliates and subsidiaries. Developing countries have to generate the informational capacity and business intelligence to be able to track foreign investor behaviour far more effectively and efficiently than at present in order to be able to factor the implications of this dynamism of MNEs into their FDI policy frameworks. In this respect the digital and innovation divides are major obstacles preventing Africa from engaging its economy with that of the world. While the impact of regional economic integration (REI) has not been touched on for purposes of brevity, clearly there is a role for this kind of economic development as it has a direct effect, *inter alia*, on market size. Regional economic integration also has the effect of enabling MNEs to exploit the differences in locational factor cost structures, inherent at different stages of development, by linking different stages of production with different locations within the region.

Promoting investment in developing countries and Africa presents many challenges and opportunities which are reflected in the challenges facing MNEs in the new economy. With respect to the change from sequential market entry with “stand-alone” operations to dynamic market entry using co-ordinated networks, developing countries would need to craft their FDI reception regulations to enable the intensification of linkages between affiliates and local firms. Regarding ownership, the preference for uncontested rights is changing to a preference for real options allowing more flexibility in response to changing marketing conditions. Developing countries would need to move towards a better sequencing of greater modal neutrality in their FDI policy regimes. Ultimately FDI, as an international business decision, relies on the cross-border functions of business being executed with competence and entrepreneurship by organizations that demonstrate viable corporate cultures able to anticipate and respond to change. Developing countries would need to mimic the best managerial practices evident from the track-record of successful and excellent international companies with respect to the implementation of FDI regimes in legal interpretation, consistent official behaviour of the highest integrity,²³ and demonstrated willingness to adopt a strategic vision of the long-term

23 Transparency International thus states that: “Political elites and their cronies continue to take kickbacks at every opportunity. Hand in glove with corrupt business people, they are trapping whole nations in poverty and hampering sustainable development. Corruption is perceived to be dangerously high in poor parts of the world, but also in many countries whose firms invest in developing nations... Corrupt political elites in the

nature of economic development that must be built layer upon layer on the competent management of resources.

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