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Promoting investment in developing countries (with special reference to Africa) –
Challenges, opportunities and experiences

Vienna, Austria

Round Table 5

Promoting investment in developing countries (with special reference to Africa) – Challenges, opportunities and experiences

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Abstract

This paper indicates the broad pattern of Foreign Direct Investment at global and regional levels. It addresses the key problematic of asymmetries within the pattern as well as the major issues pertinent to developing countries and the least developed countries, particularly those in Sub-Saharan Africa – where the problem is greatest, and the challenges of crafting policies to attract, retain and increase Foreign Direct Investment. The major issues are seen as how developing countries exploit motivations for Foreign Direct Investment; the ways in which developing countries can maximize positive externalities from Foreign Direct Investment while minimizing negative spillovers; and the empirical evidence indicating that, with well-articulated policies, the benefits of Foreign Direct Investment can be substantial for the industrial development of developing countries.

Part 1: Introduction

The pressing issues within the dynamics of international capital flows and the organizational behavior of the principle actors in the world economy -- MNEs and the state [Stopford, Strange and Henley (1991)] are best examined through a lens that focuses on the international business of Foreign Direct Investment (FDI). While a positive economics, in contrast to a normative perspective, is assumed in this paper a major issue of contemporary concern is one that relates FDI to increasing industrialization and the reduction of poverty. This issue finds its most vivid expression in relation to the marginalisation from FDI of Africa. Evidence suggests that not only does increasing FDI stock to GDP ratio positively correlate with a decreasing share of the population living below US$1 per day [OECD (2002)] but also increases in FDI are correlated with industrial development [UNIDO (2002); World Bank (1993)]. It would appear that this correlation is not making the kind of impact in Sub-Saharan Africa (SSA) that the international community would expect.

Nevertheless, firstly that FDI flows, and resulting accumulations of FDI stock, are asymmetrically distributed between the industrialized and developing countries

(DCs)[1] in powerful favour of the former is provided by well-established empirical evidence and research [UNIDO (2002);UNCTAD (1991-2002); OECD (2002); Buckley and Casson (1976, 1985)]. Secondly, and equally well founded, is the highly skewed distribution of FDI across the geo-economic landscape of the developing countries [UNIDO (2003)] benefiting a few hosts at the expense of the majority[2].

These twin asymmetries, find challenging industrial expression, at the macro-, meso- and micro-economic levels. First in terms of the predominance of the TRIAD of North America, Europe and Japan as hosts to, and sources of, FDI. Secondly, in terms of areas of robust regional growth[3]. Thirdly, in terms of the local embedding of FDI decisions at individual cities and localities that display an attractive dynamism[4]. The asymmetries in the growth pattern of FDI can be explained econometrically by differences not only in costs between countries but also, and perhaps more importantly, because governments and their policies differ in credibility [Janeba (2001)]. To give illustration of the asymmetries, a comparison of the distribution of FDI stocks, expressed in terms of major partners, in 1985 and 2001[5] mentions only Egypt, Nigeria, Tunisia and Zimbabwe; and Egypt, Kenya, Morocco, Nigeria, South Africa, Swaziland, Tunisia as partners to the European Union (EU) respectively – an addition of three over a 15 year period. For the USA and Japan as sources of FDI stocks, there were no African partners mentioned for either 1985 or 2001.

This paper does not take issue either with the problematics of measurement [Lehmann (2002)] or distinction between gross and net FDI, and their statistical terminology. It takes it as given that the FDI increases recorded by the IMF in its international finance statistics are representative. But this is far from a trivial matter because, in the co-operative and conflictual bargaining relationships between Host governments and investors, firms' investment choices concern different components of FDI.

Since about 1980, two key developments have determined the industrial organization of Multinational Enterprises (MNEs) and increases in FDI activity. The first is the extension of policy liberalization, under multilateral trade agreements and pressures for structural adjustment, as well as intensive competition between countries focused on capturing the beneficial impacts of FDI [Oman (2000)]. This liberalization has led to decreasing costs of both cross-border trade and FDI. The second is the spatial location and dynamic distribution of manufacturing and services (in both horizontal and vertical FDI) within industrialized and across developing countries, and especially in Southeast Asia. This spatial distribution, driven by MNEs' competitive search for efficiency gains in response to increasing production costs and the perils of

[1] Economies in transition are included in this category for brevity.
[2] See UNIDO (2003), Table2, p. 4 for the profile of FDI shares that accrue to developing regions.
[3] For example: the growth corridor of Europe that runs in an arc form Southeast Britain via the engineering heartland of Germany to the innovation parks of Southern France and Northern Italy; the growth triangles of South East Asian; and special economic zones of Coastal China.
[4] For example Singapore and Bangalore on one hand and the cluster of northern 'Maquilladora' cities of Mexico on the other hand.
[5] UNCTAD, 2003, World Investment Report, Figure I.14, p. 24, "FDI stocks among the Triad and economies in which FDI from the Triad members dominate, 1985 and 2001.

exogenous shocks[6], is hallmarked by the strategic integration of MNE headquarters, subsidiaries and affiliates. With respect to Southeast Asia, this distribution has distinctive trade characteristics, exemplified by Vertical Intra-Industry Trade (VIIT) and exports in a relatively narrow range of product categories[7].

Notwithstanding the argument about the balance between the quantity and quality of FDI, since 1980 relatively few developing countries (or regions) have demonstrated a consistent capacity for, and capability in, attracting significant levels of FDI[8]. There has been a significant growth of foreign investment flows to DCs and least developed countries (LDCs) from below US$50 billion in 1990 to about US$200 billion in 2000 [UNIDO (2003)]. The distribution of this growth is presented in table 1- regional FDI inflows for 1980-2001, % of total. Global FDI flows grew from US$52 billion (1980) through US$202 billion (1990) to a peak of over US$1,400 billion (2000) before falling off to US$490 billion (2002).

[6] Such as the 1973/74 and 1979/81 oil price shocks.
[7] In the electrical machinery industry, the share of VIIT in total trade in East Asia grew from 31% in 1996 to 43% 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 figures are as follows: Indonesia 2% (1988) to 39% (2000); Malaysia 40% (1988) to 34% (2000); Philippines 16% (1988) to 55% (2000); Singapore 17% (1988) to 43% (2000); and Thailand 16.5% (1988) to 41% (2000). Source: Fukao F., Ishido H., Ito K. (2003) Vertical Intra-Investment and Foreign Direct Investment in East Asia, presented originally at the 15th Annual Trade Conference, New Development in International Trade, 10-11th December 2002, Tokyo, p. 10, Figure 2-6(b).
[8] See UNIDO (2003) and UNCTAD (2002, pp. 25-26) for a view of the FDI potential and performance indexes of industrialized and developing countries. It should be noted that for many developing countries, absolute levels of FDI may be less significant than the FDI to GDP, FDI to gross capital formation and FDI per capita ratios.

Table 1: Regional FDI Inflows for 1980-2001, % of Total[I]

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Industrialized Countries	89.04	68.69	56.22	66.92	72.76	75.09	84.50	90.03	85.85	87.03	85.19
North Africa	0.25	0.56	0.49	0.81	1.57	2.56	1.31	0.78	0.92	0.85	0.56
Central Africa	0.43	0.37	0.57	0.82	0.16	1.25	0.40	0.31	0.25	0.06	-0.17
Western Africa	-0.97	0.99	1.15	0.88	0.53	0.85	0.16	0.63	0.30	1.08	0.44
Eastern and Southern Africa	0.58	0.18	0.13	0.16	0.17	0.30	0.23	0.24	0.15	0.22	0.25
Latin America	12.33	12.98	12.54	11.01	7.49	10.33	5.37	2.90	4.79	4.02	4.05
West Asia and Europe	-6.42	10.37	21.21	10.98	9.63	1.72	1.54	-0.73	0.30	0.22	1.28
South and East Asia	4.75	5.85	7.69	8.42	7.71	7.91	6.49	5.84	7.43	6.52	8.40
TOTAL REGION	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Industrialized Countries	76.00	72.82	70.06	62.43	69.98	65.96	65.20	74.51	82.26	85.75	86.62
North Africa	0.52	0.90	0.74	0.90	0.26	0.22	0.27	0.29	0.15	0.17	0.08
Central Africa	0.42	0.27	0.11	0.05	0.09	0.02	0.02	0.18	0.21	0.00	N/A[I]
Western Africa	0.61	0.51	0.71	0.99	0.51	0.59	0.51	0.24	0.16	0.02	N/A[I]
Eastern and Southern Africa	0.22	0.19	0.02	0.18	0.29	0.26	0.26	0.22	0.13	0.07	N/A[I]
Latin America	8.37	9.00	6.36	11.91	9.39	11.84	14.37	10.71	8.15	5.21	7.80
West Asia and Europe	1.39	1.64	1.50	0.83	-0.06	0.83	1.22	1.07	0.31	0.12	0.83
South and East Asia	12.46	14.68	20.50	22.71	19.53	20.27	18.13	12.77	8.62	8.68	4.66
TOTAL REGION	**100.00**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100. 0**	**100.0**

[I] SOURCE: UNIDO Statistics compiled from International Finance Statistics (from International Monetary Fund) according to UNIDO List of countries and areas included in selected groupings in the International Yearbook of Industrial Statistics 2002

Table 1 also shows that, in terms of share of FDI, while Industrialized Countries have maintained their lion's share (dropping from 89% to 87%) over two decades with a low point of 56% in 1982 and a high point of 90% in 1987, four African regions[9], West Asia and Europe[10] have lost out heavily to the countries of South and East Asia and Latin America. Within Asia the main beneficiaries of cumulative FDI inflows over the two decades have been in South and East Asia, in particular China, Hong Kong SAR, Singapore and Malaysia; in Latin America – Brazil, Mexico, Argentina and Chile have attracted large volumes of internationally mobile capital. Since 1990, the investment flows to SSA have collapsed. In 2000 FDI inflows were relatively low and extremely so for the four African regions that received only 0.26% of the total FDI inflows. Cumulatively Egypt, Nigeria, Angola and Tunisia have received the bulk of the low volumes of FDI to Africa. In West Asia and Europe the largest cumulative flows of FDI have been hosted by Saudi Arabia, Turkey, Bahrain and Croatia. Latin America having performed relatively weakly in attracting FDI in the later part of the 1980s has proved a stronger magnet for FDI in the 1990s. South and East Asia has consistently shown improvement in attracting FDI throughout the last 20 years (despite cyclical downturns) until the hiatus of the Asian economic crisis of 1997.

In general, among developing countries, South East Asia's performance appears to have out competed Latin America and Africa and in particular Sub-Saharan Africa's performance appears with few exceptions[11], to have dimmed considerably. Within the constraints dictated by the Scylla and Charybdis[12] of government failure and market failure [Wolf (1979,1988); Le Grand (1991); Greenwald and Stiglitz (1986); Le Grand, Propper and Robinson (1991)] and implicit in the differentiated national and regional performance is the central issue that different government policies, in so far as they attenuate or strengthen industry structure on the one hand and moderate or amplify transaction costs on the other hand, have created different combinations of increases (decreases) in market imperfections that repel (attract) the attention of MNE's FDI.

The factors that animate the morphology of international FDI, its flows and industrial dynamic [Dunning (2000, 2003)], such that the aforementioned asymmetries are persistent, need to be disclosed in terms that can be captured, and internalized, by the decision–making structures and policy communities of developing countries. The morphology of FDI appears to be characterized essentially by two vectors in dynamic tension. The first is constituted by the spatial, but uneven, distribution of productive assets and their inherent stages of production. This distribution, which is hallmarked

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9 North Africa, Central Africa, Western Africa, Eastern and Southern Africa.

10 According to UNIDO classification, this group comprises only countries of the former Yugoslavia as European, other European countries and that of the former Soviet Union are comprised under Industrialized Countries.

11 Resource-seeking FDI into oil/gas/mineral locations on the one hand and efficiency-seeking FDI into South Africa, for example, on the other hand.

12 In Greek mythology, the two immortal and irresistible monsters who beset the narrow waters traversed by the hero Odysseus in his wanderings (later localized in the strait of Messina)[Britannica, Vol. 10, p.576].

by the interactions of MNEs, changes constantly as MNEs competitively configure and recalibrate their operations and relocate them in response to competitive pressures. The second vector is rooted in the capability of MNEs for governance, by managerially coordinating and controlling the functional relations of sourcing, technology, production, marketing and servicing within their organization. Whereas, the first vector is disintegrative, the second is integrative [Bartels and Pass (2000), Dicken (2003)].

These fundamental features of modern industrial organization are motivations for renewed policy action and need to be more fully appreciated by a wider leadership in developing countries.

Furthermore, the efficiency of modern industrial systems, and differentiated manufacturing stages therein, is such that there tends to be over capacity in production[13]. The implication of this broad view of industrial dynamics and investment is that, in general, developing countries, and in particular the LDCs in Africa, have to work harder and smarter as potential hosts to capture the FDI attention of the approximately 65,000 MNEs and their over 850,000 subsidiaries that together account for about two thirds of global trade [UNCTAD (2002)].

Regarding the integration of world economic activity, it is noteworthy that at the global level, three major divergences, with profound implications for developing country host government FDI policies, have occurred since the post war era. First, in the face of falling barriers, post-1960, global trade rate of growth far exceeds that of global production implying trade as the integrating factor. Secondly, post-1985 global FDI rate of growth far exceeds that of global exports. This implies FDI (notwithstanding the fall off of FDI between 2000 and 2003) and inter-, intra-firm transactions have superceded trade as the integrating factor of the global economy [Dicken (2003)]. And thirdly, capital and financial market performance indicators[14] between high-income and middle- and low-income countries have diverged. Thus implying that the role of capital markets is increasingly crucial to the operationalization of FDI, which in turn is correlated positively to capital raising, stock market listing and securities trading in international financial centers [Claessens, Klingebiel and Schmukler (2002)].

The rest of this issues paper is organized as follows: part 2 addresses the underlying rationale to the motivations for FDI and advances the case for an improved appreciation of these motivations by the policy communities in developing counties. The motivations are set in the context of government and market failures. Part 3 looks at the issues of the costs and benefits of FDI, in terms of positive externalities and negative spillovers that need to be evaluated for policy choices within the international regulatory framework provided, *inter alia*, by the WTO. Part 4

[13] The present low inflationary profile in industrialized countries and the razor thin profit margins of producers of commodities goods, in China for example is one manifestation of this trend.
[14] Market capitalization /GDP; value traded domestically/GDP; capital raised abroad/GDP; value traded abroad/GDP.

concludes with a view on the persistence of the asymmetries in FDI flows and the impact of the services economy on future directions of FDI.

Part 2: FDI rationale, motivations and their exploitation by developing country hosts

The basic premise herein is that governments of developing countries select policy choices to attract FDI in relation to overall economic development goals. These goals are encapsulated by the aim of wealth creation through industrialization efficiencies that are gained ultimately from increases in total factor productivity growth. There is general acceptance that government policies and their effective articulation can be important determinants of FDI. However, among the stark realities facing developing countries is one of boundedness. Local economies, and the states which exercise sovereignty over them, are location bound. However, the spatially distributed and internationally integrated scouring, technology, production, marketing and servicing FDI of MNEs are not territorially bound. The latter operate strategically as an inter locking matrix of networks [Kim, Park and Prescott (2003); Egelhoff (1998); Birkinshaw (1996); Lawrence and Lorsch (1967)]. The territorial freedom of these cross-border networks, and their organizational functions, present a major challenge to developing countries as they attempt to capture FDI.

The necessary, but insufficient, conditions in which motivations for FDI are actualized by MNEs appear as an investor's "wish list"[15]. If, and when fulfilled, they manifest as an enabling host environment. The sufficient conditions are framed by the taxonomy of FDI motivations[16] [OECD (2002); Dunning (2000); Brook and Buckley (1988)]. The taxonomy reduces parsimoniously to firm specific advantages of ownership that are matched with national location specific advantages and overlaid by internalization advantages that allow MNEs to execute cross-border transactions within the organizational boundary of the firm rather than through external markets (which are subject to Williamsonian market failure[17]).

[15] 1st- Political stability (because capital investments are time framed longer than incumbency of elected governments or electoral cycle), 2nd- Economic stability (economic strength through 'fabric' of inter-transactions, intermediation, sub-contracting that is robust), 3rd- International outlook (global in thinking/behavior with respect to best practice and policy framework), 4th- Government regulations (clarity and consistent interpretation of rules; purpose of regulations), 5th- Infrastructure (distribution logistics efficiencies and operabilities; data communications/infrastructure), 6th- Labour (profile of skills), 7th- Banking/Finance (strong intermediation capabilities and capacities), 8th- Government attitude (service orientation), 9th- Local business infrastructure (backward and forward linkages) and 10th- Quality of life (personal safety/health/education lifestyle).

[16] Host market-oriented (comprising socio-demographic and socio-economic properties); cost-oriented (constituted by efficiency properties of production); vertical integration oriented (involving the input-output relations of raw materials and intermediates); investment climate oriented (related to "soft" and "hard" infrastructure); response to "pull" forces (from distributions or agents); and response to "push" forces (from source country).

[17] Williamson (1975) refers to market failure due to dynamic complexity, bounded rationality, information asymmetries, asset specificity, the dominance of the few in industry supply and demand factor markets, and opportunism.

The boundedness of sovereign economies with respect to MNEs FDI implies that, on balance, host countries would need to pay crucially more policy attention to motivations related to location specific advantages. The sequencing of resultant policy measures cannot be effected in isolation from what other governments may be crafting in response to pressures to increase their share of FDI. The direct and indirect effects of one government's policy framework concerning the macro-economic – fiscal and monetary – variables as well as capital controls, transfer pricing, mergers and monopolies, labor relations, intellectual property protection rights and privatization would need to be seen not only in terms of the relative level of cross-national differences but also in terms of the relative rate and direction (pro- or anti-FDI) of change in those policies. For example, privatization may not necessarily lead to increased FDI if a neighboring country has a more extensive programme coupled with a liberalized trade regime.

That said, government policy reflects the collective interests of the dominant social-economic groups which control the apparatus of the state [Olson (1967)]. The national and regional articulation of a given set of government policies that produce market imperfections to foster conditions conducive to FDI may have variations that have countervailing effects on FDI. One illustration is government procurement and to what extent it is discriminatory - are all FDI subsidiaries prevented from bidding irrespective of location within the country or are foreign owned domestic firms granted the same bidding rights as domestically owned firms? The former case represents a higher level of market imperfection compared to the latter which has a positive impact on FDI since government markets can be contested through FDI with, for example, mergers and acquisition entry modes. Another example is inbound trade quotas in that such a policy increases FDI in the protected market. However, FDI may actually increase not in the protected market but in a third host that either faces no quotas or has unfilled quotas [Brewer (1993)].

At the regional level, reflecting trade-creating and/or trade-diverting outcomes of trade arrangements, regional FDI arrangements[18] can decrease intra-regional market imperfections thus increasing intra-regional FDI. When coupled with common external tariff protocols, such agreements can also increase FDI into the region.

Due to the networked nature of integrated international production, policy makers in developing country hosts need to perceive MNEs FDI as a multifaceted organizational decision process that evolves over time with respect to entry mode, reinvestment, intra-company debt transfers and project expansion as well as industry sector competitive dynamics. This presents a major challenge for the analytical capacities of investment boards, investment promotion agencies and institutions in developing and least developed countries that must engage in policy analysis and advocacy, and feed advise into national decision-marking structures.

[18] For example ASEAN Investment Area, Andean Common Market.

Table 2: Comparative policy effects on market imperfections and inward FDI.

	Effect on market imperfection	
Effect on FDI	Increase	Decrease
Increase	▪ Protectionist import policies ▪ Weak IPPRs ▪ Subsidies on In-FDI ▪ Undervalued exchange rate ▪ Weak competition policy ▪ Procurement discrimination vs. foreign (non-domestic) firms ▪ Technical standards	▪ Liberalization of FDI regime ▪ Privatization ▪ Foreign exchange convertibility ▪ Anti-dumping policies ▪ Import duties on subsidized exports from other countries ▪ National treatment ▪ Strong competition policy ▪ Tariff debates on imports for export oriented FDI ▪ Liberalization of trade restrictions
Decrease	▪ Overvalued exchange rate ▪ Restrictions on In –FDI ▪ Price controls ▪ Import restrictions on FDI inputs ▪ Export controls on FDI outputs ▪ Restrictions on capital access ▪ Restrictions on capital repatriation	▪ Strong anti-monopoly policy enforcement ▪ Strong arm's length transfer pricing policy enforcement

Adapted from Brewer (1993)

The analytical challenges of policy formulation and dynamic reconfiguration of policy presented by table 2, especially for resource constrained African countries, are not to be underestimated. For example, incentives such as subsidized loans can alter the ratio of foreign to local in the capital structure of the FDI and hence the relative volumes of foreign to domestic investment. The FDI motivations referred to earlier therefore need to be appreciated as being amenable to amplification by the policy prescriptions of developing country hosts. However, changes in policy need to be set in a tri-lateral policy framework of modal neutrality, market contestability and policy coherence[19]. Signaling changes in policy would need to be well-timed, transparent and consistent with overall industrial development goals.

[19] Modal neutrality describes policies that allow foreign investors to decide for themselves how best to serve the markets they enter. Market contestability embodies the ability of both foreign and domestic investors to compete on a level of playing field for the factors of production. Policy coherence refers to the degree of internal consistency of objectives, FDI policies and interpretation of policies, in their regulatory form, across a range of issues and at different level of Government.

Host governments, specifically those in Africa, therefore have to select carefully what FDI motivations they wish to target and consequently bargain for over time with policy settings that change according to the nation's developmental stage. However, they have to make their selections with respect to state-firm and state-state relations in the context of policy competition for FDI [Oman (2000)]. This in turn implies not only specifying policy for inter-industry linkages and technology requirements but also implementation strategies that pay attention to the regulatory behavior of national institutions in attracting FDI.

With respect to developing and least developed countries positioning themselves to successfully exploit the motivations for FDI, fundamental questions remain. How do DCs and LDCs configure institutionally their policy setting to capture FDI efficiently when the setting needs to address non-tariff barriers, technical barriers to trade, technical standards, TRIPS and TRIMS[20]? What is the configuration of obstacles that prevent the knowledge-based institutions in DCs and LDCs from contributing more significantly to FDI policy research and analysis? How may the obstacles be overcome? Given the established positive link between regional integration arrangements (RIAs) and FDI [Yeyati, Stein and Daude (2002)][21] what mechanisms and processes are available to DCs and LDCs for overcoming fragmented regional markets (especially those in Africa)? How do DCs and LDCs 'race to the top' in attracting FDI in preference to the 'race to the bottom' through incentive wars?

Assuming that DCs and LDCs can exploit favorably the motivations for FDI, such that FDI is directed to strategic industrial sectors, there remain equally important issues about the comparative benefits and costs of FDI and their macroeconomic impact on host economies. Ultimately, DCs and LDCs need to maximize benefits while minimizing costs in a sequential dynamic of calibrating and recalibrating their investment regimes as a function of their evolving stage of development, and changing industrial development goals. This is particularly important for those African countries that are lagging behind in the competition to attract FDI.

Part 3: Balancing the externalities from FDI in favor of the positive

For our purpose, the issues concerning benefits and costs of FDI are more usefully examined in terms of externalities (or spillovers) and whether in sum they can be made positive in favor of the developing host. Whereas externalities are viewed often in macro-economic terms, from the perspective of industrial development, positive externalities are best seen at the enterprise level, because FDI decisions are ultimately business decisions. The tentacular presence of MNEs in a large number of DCs and LDCs has focused attention on MNEs as organizational powerhouses with economic capabilities that often transcends that of individual sovereign states. As indicated previously, a country is, by definition, a fixed entity; the MNE, in contrast, constitutes

[20] Trade Related Intellectual Property Rights and Trade Related Investment Measures.
[21] The regression analysis study of FDI stocks from 20 OECD source countries to 60 host countries between 1982 and 1998 comprising 6768 observations shows that on average common membership in a RIA comprising a free trade area with a FDI source country increases two-fold the bilateral stocks of FDI.

a package of resources which can be deployed between countries. As the deployment takes the form of 'slicing up' of industry and firm value chains and their location across borders for manufacturing goods in different stages at different locations which add value at each state, ensuring a balance in favor of positive externalities represents major challenges to DCs and LDCs.

The challenges presented by the relative costs and benefits of FDI are usually framed on the one hand by the impact on national economies in terms of relative loses and gains between industrialized sources of, and DCs/LDCs host to, FDI. And on the other hand by economic as well as socio-cultural effects. The externalities (spillovers) should not be considered in isolation from the various interest groups[22] who are affected by FDI. The inherent issues revolve, inter alia, about differences in deceleration or acceleration in output and employment; advances or declines in the balance-of-payments and trade; and decrease or increases in competitiveness. There are also considerations of capital, skills, resources and technology transfer dependence by the host on the source of FDI. Furthermore, issues of sovereignty and the possibilities for manipulative transfer pricing by foreign investors [Plasschaert (1994)], the creation of FDI enclaves and the encouragement of rural-urban migration as well as cultural change resulting from FDI imposes additional policy challenges on decision-makers in DCs and LDCs.

The 'obvious' benefits arise in general from the well-acknowledged fact that FDI helps to fill a number of 'gaps' including those of technology, capital investment, foreign exchange, management and budget. However, these are beneficial in sum only if firstly the host can capture efficiently the associated externalities. And secondly, if the returns on FDI are not entirely absorbed by the investor. Issues that arise concern macro-economic effects and improvements in terms of trade gained through access to, and integration with, the marketing networks of MNEs, which have to be weighed against 'crowding out' problems. Of course, the ability to capture the positive externalities of FDI very much depend on the stage of development of the developing countries. Countries at different points of the developing trajectory – broadly speaking commodity factor or resource-based, FDI-driven, and innovation-driven – can capture, or maximise, different aspects of the full range of positive externalities [Porter (1990)]. In general the less advanced the developing country, the lower the range of positive externalities that can be captured whereas the more advanced the developing country the more positive externalities that can be locally embedded. The implication herein is for countries to move as rapidly as possible through the stages of development from factor-driven to innovation-driven development.

At the intra-country level, the potential benefits of lower consumer prices and higher labour wages from domestic market servicing FDI would need the riders – for which groups of consumers, and what domestic sectors may loose out? Additionally, what is the quality of jobs being created - low capital to labour ratios capable of upgrading or not? Is labour unionism emasculated or will conditions be conducive to higher rates of training? And with respect to inter-sectoral inequalities, to what extent is rural-urban

[22] Government, workers in labour unions, customers and consumers, suppliers and competitors.

drift affecting agri-business for those DCs and LDCs whose economies are primarily commodity and resource driven?

Regarding the competition and monopoly aspects of FDI, precisely because MNEs have overwhelming firm specific advantages - referred to as monopolistic-oligopolistic advantages by Lall and Streeten (1977) - relative to domestic firms, without robust policies FDI can lead to market failure, manifest in resource misallocation, higher local pricing [Vaitsos (1974)], lack of choice and alteration of local consumption patterns.

The positive externalities manifest as benefits of FDI would need to be weighed against the cost of offering incentives. Here, the central question is to what extent do DCs and LDCs compete to offer incentives in a race to attract FDI in such a manner that environmental and other standards are raised rather than lowered? This is far from trivial as different socio-economic groups may loose or gain. Oman (2000) delineates the incentives and policy competition for FDI among countries and highlights the fact that for DCs and LDCs this competition comes not only from among themselves but also more importantly from the industrialized countries which have greater financial resources with which to influence market imperfections.

These issues are not easily tractable and require high quality policy analysis resources on the part of DCs and LDCs investment promotion agencies.

The effect of FDI on national planning revolves about the issue of the fundamentally co-operative or conflictual bargaining between MNEs and hosts because whereas investors have primarily responsibility to their shareholders, governments have primarily responsibility for their citizens' welfare. These two sets of responsibilities do not necessarily coincide at all times. Whereas host governments are primarily concerned with strategic economic security, socio-economic considerations and potential loss of economic sovereignty; the main considerations of MNEs are to do with the rights to intellectual and physical assets protection as well as the unhindered ability to decide how best to operate their business in terms of deploying and managing human, financial and technological assets. At a regional level, intra-MNEs trade may negate the social function of the market when domestic firms are excluded, because of technical incapacities, from MNEs supply relationships. Despite incentives, without policy coherence, and faced with perceived high taxes, foreign investors with extensive production networks can indulge in international transfer pricing to reduce their global fiscal liabilities to the detriment of national balance-of-payments and developing country treasuries and thus potentially reducing the effectiveness of national fiscal and monetary policy.

Regarding the effects of FDI on economic development, while DCs and LDCs can benefit from exemplary indications from Southeast Asia and leading countries in Latin America and North Africa, externalities have to be well-configured for maximizing benefits. For example, the demerits of FDI can include on the one hand enclave creation that can stimulate uneven development. There are a number of examples of enclave creation in Sub-Saharan Africa that have led to economic tensions. On the other hand, an over concentration on resource-oriented FDI can lead to export earnings that are subject to relatively large international price fluctuations. Anecdotal evidence is available that 'sweat shops' associated with FDI can lead to exploitation of workers and child labour.

Overall, notwithstanding pressures for investment rules[23], the above issues present to DCs and LDCs the challenge of crafting FDI policies with the requisite system of incentives that are able to take advantage of WTO non-actionable subsidies.

Part 4: Concluding remarks

Notwithstanding the complexity of issues raised above, empirical research indicates that the crucial areas of impact of FDI on host country effects are: (a) host country wages in terms of wage comparisons between foreign and domestic investors, and wage spillovers as well as average wages; (b) host country productivity in terms of productivity comparisons of foreign and domestic manufacturing as well as productivity and knowledge spillovers to domestic industry; (c) introduction of new industries and host country export performance; and (d) host country growth.

The challenge for decision-making structures in DCs and LDCs is to fully appreciate the dynamics of FDI in general, and within these above mentioned areas in particular, so that FDI regimes that are coherent and effective may be created to attract the desired type and quality of investment. The persistent twin asymmetries of the vast majority of FDI going to industrialized countries and to a few within developing countries suggest that the bulk of developing countries continue to face serious issues. The economic and organizational power of MNEs is such that calls for monitoring their operations[24] have been intermittent since the 1970s [Soros (1998); Servant-Schreiber (1980); Vernon (1971)].

The DCs and LDCs, especially Africa, face a new challenge with respect to international investment – that in service industries. Reflecting the international relocation of production throughout the 1980s and 1990s, service industries are going global[25] in search of relatively low costs to perform functions with high quality. In this new round of globalization, again it would appear that the Indian Ocean Rim countries are capturing the lion's share of this FDI in services[26] and African countries, having largely missed out on the first wave of the international relocation of production, appear to be poised again to loose out on this second wave of the international relocation of services. This is worrying as African countries have international language skills based on their relations with their former metropolitan

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[23] See Noboru Hatakeyama, The World Need Investment Rules, Financial Times, 1st August 2003, p. 13.

[24] Jonathan Birchall, UN looks to keep check on multinationals, Financial Times, 13th August 2003, p.1 and p. 4.

[25] See Outsourcing - Service industries go global: how high-wage professional jobs are migrating to low-cost countries, Financial Times, 20th August 2003, p. 11 in which computing and language skills play key roles in this outsourcing.

[26] The New Global Job Shift, Business Week, 3rd February 2003, pp. 36-48 for a view on the kind of services being internationally relocated.

powers means[27]. The requirements for DCs and LDCs to set policies to amplify their location specific advantages in order to attract some of this FDI in services, so that managerial skills transfers can be captured, presents a serious issue.
Nevertheless, the empirical evidence[28] suggests powerfully that foreign investors pay higher wages than their domestic counter parts. Also the presence of FDI raises the average level of wages. As with wages, productivity studies show that foreign-owned firms demonstrate higher productivity levels than domestic firms. Even though indications of productivity spillovers to domestic firms are mixed, the presence of FDI leads to an overall improvement in productivity. It is also found that foreign investors contribute knowledge, particularly about demand in global markets, to the domestic economy. Finally, through these combined effects, and the introduction of new production techniques, FDI is associated with accelerated economic growth.

Of course, precisely because accelerated economic growth by definition involves punctuated equilibrium at sector level and therefore disruption to established domestic economic patterns, the issue of the preference for the stability of industrial organization (in terms of traditional skills for example) over economic progress remains to be resolved. There are winners and losers, benefits and costs, in FDI. Gains would need to accrue to broader rather than narrow interests. Costs and losses would need to be moderated by DCs and LDCs policy decisions to foster efficient economy, sound environment and productive employment. The challenge to African countries in general remains serious and there is a need for well-articulated policy solutions.

Summary

This issues paper presents a number of key issues that affect, to greater or lesser extent, developing countries in their attempt to capture Foreign Direct Investment. The asymmetries in the distribution of Foreign Direct Investment, and the lack of domestic investment in much of Africa give serious cause for concern. The key issues identified are:

1. The highly asymmetrical pattern to global in flows and stocks of Foreign Direct Investment (FDI) and of the international location of the subsidiaries, affiliates and productive assets of Multinational Enterprises (MNEs).
2. The dominance of industrialised countries as hosts to, and sources of FDI.
3. The dominance of a few developing countries as hosts to FDI.
4. The almost complete marginalisation of Africa in general, and Sub-Saharan African in particular, from mainstream manufacturing and export-oriented FDI.
5. The challenge faced by developing countries in exploiting the motivations for FDI by MNEs.
6. The challenge faced by developing countries in crafting policy solutions that maximise the capture of positive externalities from FDI while moderating the impact of negative spillovers.

[27] The problem lies in the woefully inadequate structure of information and communications infrastructure in most African countries.
[28] See Robert E. Lipsey, Home and Host Country Efforts of FDI, monograph, NBER, 2002, for a comprehensive review of the literature.

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