ATTRACTING AND MAXIMIZING THE BENEFITS OF FOREIGN DIRECT INVESTMENT: THE ROLE OF TRADE POLICY

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Outline

- FDI at a glance
- Conceptual framework
- Host country determinants and impact of FDI
- The scope for trade policy
- Multilateral rules for FDI
- Commitment to rules or discretion
- FDI in CAREC countries

FDI at a Glance

- FDI flows have surged over the past two decades, outpacing growth in GDP and trade;
- Multinational corporations (MNCs) became important players in international flows:
  - Affiliate sales are double of world exports
  - One-third of global trade is intra-firm
  - Subsidiaries generate 53 million jobs

FDI: Developed Countries

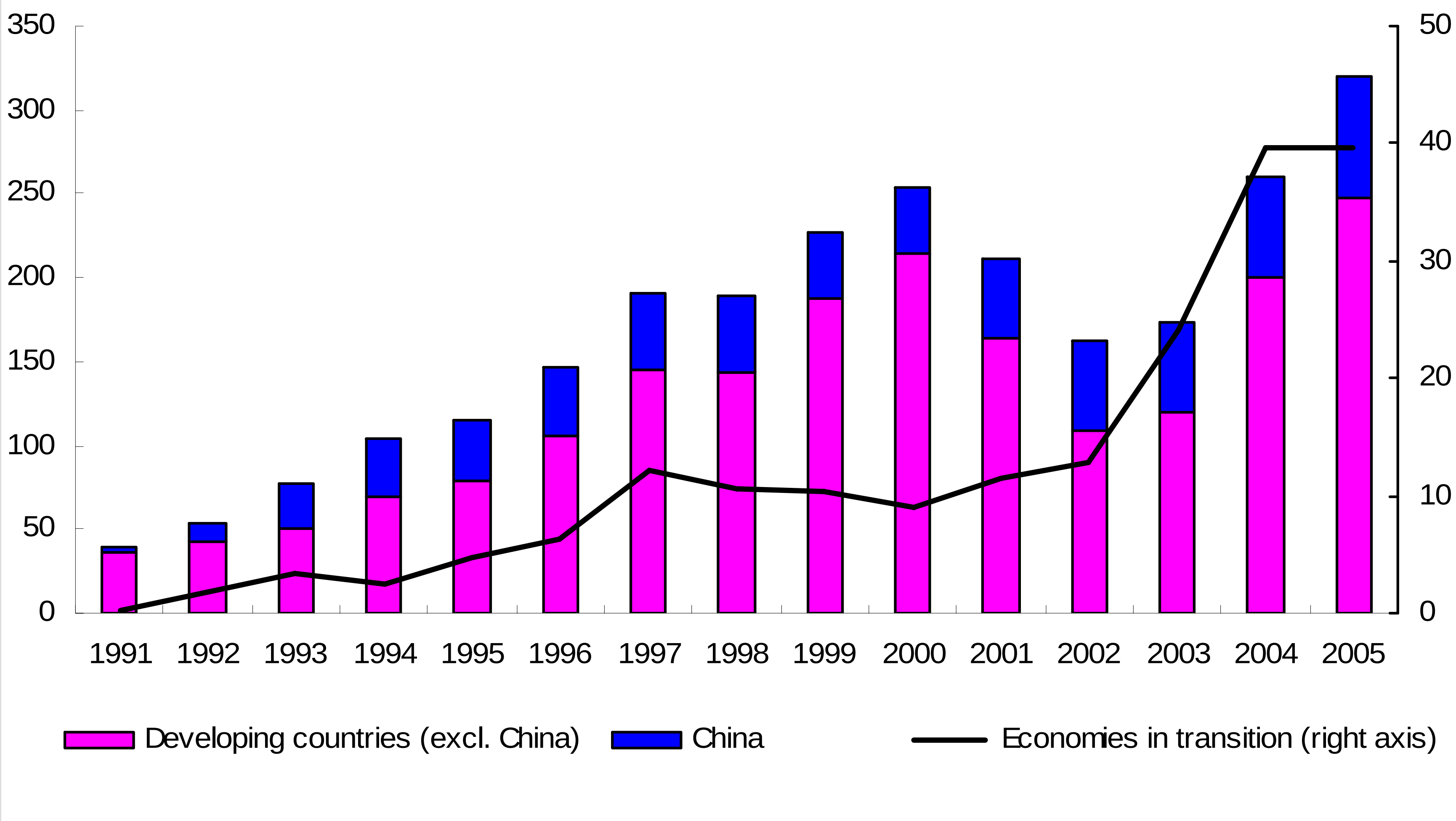
- Developed countries are both the major source and recipient of FDI
- In 2005, 59% ($542 billion) of global inward FDI went to developed countries
- FDI is driven, to a large extent, by market access motives (horizontal)

FDI: Developing Countries (1)

- Since 1990s, more favorable view of FDI:
  - Large potential gains to host countries
- FDI became the largest source of external finance
- But most have gone to more advanced developing countries and to China

FDI: Developing Countries (2)

FDI inflows in billion US dollars, 1991-2005.



Source: UNCTAD and IMF staff estimates.

FDI: Developing Countries (3)

- FDI is motivated by savings from fragmenting production to exploit factor-price differences across countries (vertical)
- Fragmentation implies large trade in inputs and intermediates
- Requires capacity to move large shipments quickly and cheaply across borders

Understanding FDI

- To formulate the right mix of trade and other policies, we need to understand why FDI occurs in the first place and what the implications are
- We approach the question from the perspective of developing countries

Conceptual Framework

- Dunning, 1977 and 1981
  - OLI Framework (ownership, location, internalization)
- Markusen (1984), Helpman (1994), Ethier (1986), Brainard (1993), Markusen and Venables (1998), Markusen (2002)
  - Knowledge-capital approach to MNC

Characteristics of MNCs

- MNCs tend to have high values of "intangible assets" (ownership advantage in knowledge capital)
- The knowledge capital can be supplied to foreign production facilities at low cost
- It can also easily dissipate if transferred externally. The MNC internalizes the knowledge capital by setting up a subsidiary.

Horizontal vs. vertical FDI

- Horizontal firms produce similar goods at home and in host countries. Exporting vs. subsidiary: trade-off between plant-level scale economies and trade costs.
- Vertical firms split production into stages, creating a value chain. Trade-off is between factor intensities and easiness to ship inputs across locations.

Host country determinants (1)

- Market size (horizontal FDI)
- Skilled labor endowment (both vertical and horizontal FDI)
- Relative factor endowments (vertical FDI)
- Trade costs (could trigger horizontal FDI, but definitely detrimental for vertical FDI)

Host country determinants (2)

- Strong evidence
  - Physical infrastructure
  - Legal and institutional framework
  - Political risk and instability
  - Agglomeration effects
  - Threshold per capita income
- Weak evidence
  - Taxation, primarily on vertical FDI.

FDI: Effects on host country (1)

- Extensive empirical evidence. Nicely summarized in Blomstrom and Kokko (1998) and Markusen (1998).

FDI: Effects on host country (2)

- Competition:
  - Competitive pressure from MNC can improve productivity of local firms:
    - more efficient work practices (X-efficiency)
    - modern technology
  - Pro-competitive impact is stronger the higher the host’s development level.

FDI: Effects on host country (3)

- Competition:
  - Existing domestic distortions (monopoly) may stimulate FDI into the wrong sector
  - More competitive MNC becomes monopolist
  - Welfare may suffer as MNC takes rents
  - Do not retort to investment policy, but address the initial distortion by pro-competitive measures or *trade liberalization*.

FDI: Effects on host country (4)

- Spillovers and Externalities:
  - Technology and knowledge transfer
    - Technology spillover
    - Training of local staff
    - Demonstration effects
  - Export facilitation
  - Backward and forward linkages with local firms; local content dilemma.

What is the scope for trade policy and other supporting policies?

Tariffs and nontariff barriers (1)

- Empirical studies and business surveys show that trade openness is highly correlated with FDI
- Vertical MNC will likely avoid the country altogether as high trade barriers hamper its ability to fragment production

Tariffs and nontariff barriers (2)

- May attract tariff-jumping horizontal FDI (e.g. food industry)
- FDI may flow to sector where the host does not have a comparative advantage
- FDI could squeeze out inefficient local firms protected by high trade barriers, which results in transfer of rents without benefiting consumers
- Trade liberalization would limit rent-seeking FDI.

Tariffs and nontariff barriers (3)

- Restrictions on imports of capital and intermediate goods are particularly damaging
- Trade barriers to increase local sourcing by MNC may simply increase costs and lower product's quality. MNC may choose not to enter.

Tariffs and nontariff barriers (4)

- Higher cost of importing technology or inputs may damage competitiveness of local firms, reducing potential for backward linkages with MNC
- This could hamper technological spillovers from the MNC throughout the host economy

Trade facilitation

- Efficient passing of goods through customs and ports is important for FDI (EPZs)
- Business surveys:
  - Crucial for vertically integrated MNCs
  - Could mean ”make or break” for just-in-time supply chains
- Example: Intel’s decision to locate in Costa Rica

Performance requirements and incentives (1)

- Evidence on the effectiveness of performance requirements is mixed. In many cases, they limit FDI
- Moreover, WTO's agreement on Trade-Related Investment Measures (TRIMs) prohibits members from using local content, trade-balancing, foreign-exchange balancing, and domestic sales requirement

Performance requirements and incentives (2)

- Linking fiscal incentives to performance criteria is not the first best instrument to promote FDI
- Better invest in physical, educational, and legal infrastructure
- Agreement on Subsidies and Countervailing Measures (SCM) prohibits linking subsidies to export or local content requirements

Performance requirements and incentives (3)

- There are cases when incentives led to inflows of FDI and creation of sustainable industry
- Could apply if host country has a comparative advantage, but FDI does not occur because of high fixed costs (Mexican auto industry)
- However, governments are typically bad at choosing future *winners*

Export processing zones (EPZs)

- Country opens trade in a limited area and grants preferences to exporting firms
- Evidence is mixed, but there are some success stories (Guangdong province in China)
- However, spillover effects and linkages are typically small, limited to the EPZ

Regional trade agreements (1)

- Trade preferences:
  - Intra-regional FDI: lower horizontal FDI, but possibly higher vertical FDI
  - Extra-regional FDI: higher horizontal, but lower vertical FDI
    - FDI may concentrate in one country that becomes an export -platform (Ireland in EU);
- Low MFN rates and liberal rules of origin minimize distortionary impact on FDI.

Regional trade agreements (2)

- Surge in RTAs coincided with a fall in a number of new bilateral investment agreements (BITs). Why?
- Substantive investment provisions have been increasingly incorporated into RTAs

Regional trade agreements (3)

- Investment provisions:
  - With exception of some agreements with EU or US as signatories, most RTAs or BITs do not go beyond GATS commitments
  - Agreements where EU is a partner impose disciplines in areas such as antitrust, state aids, and state monopolies.

Multilateral rules for FDI (1)

- Trade-related investment measures (TRIMs)
  - National treatment (“National Car” company status in Indonesia)
  - No quantitative restrictions on imports/exports
- The agreement covers only trade in goods:
  - does not apply to foreign investment
  - does not apply to services

Multilateral rules for FDI (2)

- General agreement on trade in services (GATS) govern trade in services;
- Mode 3 encompasses FDI, but all four modes are critically linked to FDI:
  - Mode 1 – Cross-border supply
  - Mode 2 – Consumption abroad
  - Mode 3 – Commercial presence
  - Mode 4 – Presence of natural persons.

Multilateral rules for FDI (3)

- Trade-related aspects of intellectual property rights (TRIPS)
  - Establishes international rules to protect intellectual property rights;
- Basic principles:
  - National treatment;
  - Most-favored nation;
  - Balanced protection.

Commitment to rules vs. discretion: advantages

- Reputation effects
- Binding future political leaders
- Minimize rent seeking and corruption
- Limit tax competition.

Tax competition for FDI

- Countries may engage in tax competition to attract FDI
- However, fiscal incentives are typically of second order in MNCs’ location choice
- If FDI would happen even without incentives, tax competition is a mean of rent transfer to MNC.

Commitment to Rules vs. Discretion: Disadvantages

- Bargaining over the distribution of rents
- Inability to discriminate among investment projects
- Inability to adjust for externalities.

FDI in CAREC (1)

- Until recently mostly into in resource-extraction sector (except in China)
- However, commitment to principles and rules for FDI is still crucial
- Particularly important given high costs of operating due to geographic location
- Liberal nondiscriminatory trade regime is one of the key pillars for FDI promotion.

FDI in CAREC (2)

- Large increase in FDI since 1995.

CAREC countries: FDI inflows.

	1995			2005		
	in million US Dollars	in percent of GDP	US Dollars per capita	in million US Dollars	in percent of GDP	US Dollars per capita
Afghanistan	0	0.0	0	1	0.0	0
Azerbaijan	330	10.7	42	1680	13.4	201
China	37520	5.4	31	72406	3.7	56
Kazakhstan	964	4.7	61	1738	3.1	114
Kyrgyz Republic	96	6.4	21	47	1.9	9
Mongolia	10	0.8	4	182	9.8	71
Tajikistan	10	0.8	2	55	2.3	8
Turkmenistan	233	10.6	56	62	1.1	13
Uzbekistan	-24	-0.2	-1	45	0.4	2

Source: UNCTAD.

FDI in CAREC (3)

Double taxation and investment treaties by CAREC countries

	1995		2004	
	Double taxation treaties	Bilateral investment treaties	Double taxation treaties	Bilateral investment treaties
Afghanistan	1	-	1	1
Azerbaijan	2	4	13	22
China	53	67	79	112
Kazakhstan	8	16	30	35
Kyrgyz Republic	1	10	10	26
Mongolia	8	19	32	40
Tajikistan	1	8	8	20
Turkmenistan	2	12	8	18
Uzbekistan	6	16	28	40
Developing Countries	973	792	1476	1790
Countries in Transition	198	282	494	642
World	1663	1097	2559	2392

Source: UNCTAD.

Conclusions

- Liberal nondiscriminatory trade regime
  - Low and uniform rates (Chile)
- Balanced approach to FTAs and BITs
- Effective trade facilitation
  - Singapore, Costa Rica
- Cannot design one-size-fits-all rules, but commitment to general set of principles is important.