Harnessing Foreign Direct Investment for Development

Policies for Developed and Developing Countries

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Harnessing Foreign Direct Investment for Development

Policies for Developed and Developing Countries

Overview

Revising the “Washington Consensus”

New Perspectives on Foreign Direct Investment and Development

The objective of this volume is to provide a policy-relevant synthesis of the major issues surrounding foreign direct investment (FDI) and development.

Looking at FDI projects ranging from manufacturing and assembly, to extractive industries and infrastructure, this book identifies the most important questions, introduces the latest research, addresses the major controversies, dissects the principal arguments, and draws the most appropriate conclusions for host- and home-country policy.

The result is designed to be a user-friendly guide for the community of analysts, home- and host country-government practitioners, legislators, journalists, NGOs, and other interested parties involved in debates about FDI and development.

This volume updates and extends previous work carried out under the auspices of the Center for Global Development and the Institute for International Economics. Across a broad array of issue-areas, it offers new evidence and novel policy recommendations.

Sections I, II and III ask, what is the impact of foreign direct investment on host countries in the developing world? What are the opportunities and dangers as international companies discover oil and mine copper, build power plants, fabricate auto parts, assemble electronics and footwear, set up software development labs, and establish call centers? How can developing country governments maximize the opportunities from FDI, and avoid or minimize the dangers? Can poorer developing countries use foreign investment to enhance their growth prospects, without exposing their workers to intolerable working conditions?

During the heyday of the “Washington consensus”, conventional wisdom held that foreign direct investment was “good” for development – as long as the foreign firms did not engage in flagrant worker abuse or environmental pollution -- and “the more the better”.

Is this uncritical enthusiasm for foreign direct investment justified today?

To answer this question, it will prove useful in the course of this volume to separate “foreign direct investment” into two categories: foreign direct investment in manufacturing and assembly, and foreign direct investment in natural resources and infrastructure.
Across both categories, the analysis of the impact of FDI on development has undergone a profound transformation over the past two decades.

Today, the accumulated evidence reported here shows that the “Washington consensus” is fundamentally flawed, both as a starting point for analysis, and as a guide for policy. For each of these categories of FDI, it is clear that foreign direct investment can be a force that is beneficial for development, or a force that is detrimental to development.¹

Looking first in Section I at foreign direct investment in manufacturing and assembly, the data now available demonstrate that the globalization of industry – the spread of plants producing garments, footwear, electronics, auto parts, industrial equipment, chemicals, consumer products - can indeed make major contributions to development, under some conditions, but subtract from host country welfare and hinder growth, under other conditions.

What those conditions are, and what host countries can do to maximize the beneficial effects and minimize the harmful outcomes, is the starting point for Section I of this volume.

Foreign-owned plants that are built to penetrate international markets, often as part of the parent multinational’s own supply chain, operate with the most advanced technologies and embody the most sophisticated quality control procedures. They pay wages higher than local counterparts, and, as the complexity of FDI operations increases, they seek to attract and keep skilled workers by offering superior working conditions. They generate backward linkages to local firms if the host country business climate and worker training institutions are conducive to the emergence of suppliers.

Foreign-owned plants that are built to serve protected host country markets, in contrast, consistently fail to live up to the infant-industry goal of creating internationally competitive operations. Their operations are typically sub-scale, and incorporate older technology and quality control mechanisms. Somewhat counter-intuitively, performance requirements imposed on these investors -- such as joint venture and domestic content requirements -- result in fewer backward linkages and less technology transfer than their export-oriented FDI counterparts.

The positive contribution to host country growth and welfare from FDI projects that are incorporated into the MNC parent’s international supply network is ten to twenty times more powerful than has conventionally been estimated. FDI projects oriented toward protected local markets detract from host country welfare and retard host country growth with stronger adverse effects than have previously been documented.

Section II turns to the question of how poorer developing countries – in Africa, Asia, Central America, for example -- might be able harness the benefits from FDI in manufacturing and assembly in ways that their more developed counterparts have been able to achieve. In

¹ The scope of this volume is limited to the impact of FDI on the economic and social development of host (and home) countries. While the analysis includes an examination of measures to improve the screening of outward investment from developed countries to avoid adverse environmental consequences for recipient nations, this volume does not attempt to provide a comprehensive review of the relationship between FDI and the environment.
particular, must poorer developing countries lower worker standards in order to attract foreign investors in least-skilled labor-intensive activities, like footwear and garments?

Here – in the midst of abundant evidence of difficulty and failure in attracting and using foreign direct investment to generate growth – this section gathers “good news” about poorer developing countries that have been successful, and draws lessons for other least-developed countries today. While the list of desirable attributes in creating a model investment climate is intimidating, the history of poorer host countries shows that relatively modest and eminently do-able reforms have been sufficient to draw impressive amounts of FDI. And, although pressures to lower worker standards can be formidable, poor worker treatment does not in fact act as a magnet in attracting foreign companies. The payoff from building institutions to provide even modest skill-building capacity for the host country workforce, meanwhile, is formidable.

Section III shifts the focus to foreign direct investment in natural resources and in infrastructure. It examines the special challenges of encouraging FDI in these sectors, and asks how what has often proved to be a “resource curse” can be transformed into a force for broad-based social development. Here there is startlingly new “bad news”, showing that multinational companies from the United States, Europe, and Japan have been devising sophisticated “deferred gift” and current-payoff arrangements with family members and cronies of rulers in developing countries to secure FDI concessions with favorable contract terms. Most surprisingly, these arrangements to deliver corrupt payments have not technically run afoul of the US Foreign Corrupt Practices Act or the OECD Convention to Combat Bribery. Section III therefore begins the analysis (concluded in Section V’s recommendations for rich country action) about what measures developed as well as developing countries must take to put real teeth in the joint endeavor to improve transparency about investor payments and host country expenditures, while identifying and reducing (if not eliminating) corruption.

Section IV reverses the analytical perspective, and asks what is the impact of outward investment on the developed home-countries of the multinationals? Are the gains to developing countries complementary to – or do they come at the expense of – the growth and welfare of firms, workers, and communities in the developed world? Is outward investment a zero-sum process that siphons off jobs from the developed economies, or a win-win phenomenon in which outward investment strengthens the competitiveness and job base of the home economy?

To assess the impact of outward investment, it is necessary to examine closely what would happen in the home economy if the outward investment did not take place, or did not take place as extensively, as actually occurred.

Would the home country firms that invest abroad export more from the home market if they did not establish offshore operations, thereby creating jobs for home country workers? Or would they export less, thereby eliminating jobs for home country workers?

Quite at odds with popular concern about “runaway plants”, the evidence shows that outward investment from developed countries in most cases – but not all -- actually improves the export performance of the home-based firms that create supply chains and distribution networks abroad. A rigorous appraisal of the question -- what would happen in the home economy if the outward investment did not take place, or did not take place as extensively, as actually
transpired? -- is that firms in the home economy would be less competitive, and the opportunities for “good jobs” with high wages and benefits would be fewer. Section IV devises a test to determine whether individual outward investments augment – or detract from – the wellbeing of firms, workers, and communities in the home country.

What measures can developed and developing countries take to maximize the benefits, and minimize the costs from the spread of foreign direct investment? How should the United States reshape its policies to augment the benefits for home and host countries simultaneously?

To answer these questions, Section V concludes by investigating what measures developed country governments can take to help promote beneficial FDI flows to the developing world, retard or screen out harmful FDI flows, enhance transparency, reduce corruption, and improve dispute-settlement mechanisms. Section V shows that the policies of rich states fall far short – in many areas -- of what can be done to enhance the contribution of foreign direct investment to developing country growth and welfare.

Against standards of what would best promote developing country growth, Section V ends with an assessment of current policies and procedures as practiced by the United States. Here the gap between US rhetoric of support for FDI flows that can benefit developing countries, and actual US practices that fail to provide such support, is striking.
Section I

Using the Globalization of Industry to Transform the Development Trajectory of Host Countries

What is the impact of foreign direct investment (FDI) in manufacture and processing on the growth and economic welfare of developing countries?

Are there dangers as well as opportunities associated with FDI?

How can developing countries design policies toward FDI to capture the benefits, and avoid harm?

The answer to these questions is found by examining evidence that has emerged over the past two decades about two rival approaches to using foreign direct investment to enhance host country economic development.

One approach to FDI– originating in export-led growth strategies in Singapore, Hong Kong, and special zones of Malaysia – was that manufacturing multinationals should be allowed to establish wholly-owned subsidiaries to assemble duty-free inputs to send into world markets. The fear on the part of development strategists in host countries was that this approach would lead foreign investors to set up no more than “screwdriver” operations, with minimal use of local components and few backward linkages into the domestic economy. The contribution to host development would be limited to putting cheap local labor to work, and to earning a small amount of foreign exchange equal to the difference between the exported products and the imported components.

A second approach to FDI – incorporated into import substitution policies in Latin America, Africa, the Middle East, and parts of Asia – was that host authorities should impose performance requirements on manufacturing multinationals, mandating that they take national partners and meet specific domestic-content targets. The hope associated with this approach was that the performance requirements would ensure technology transfer to local companies, generate backward linkages, and build an indigenous industrial base in the host economy.

In the 1970s and 1980s early debates about how best to harness non-extractive foreign direct investment for development raged largely on the basis of ideology, not empirical analysis. By the early1990s, however, sufficient evidence was beginning to accumulate to show that these contrasting approaches to foreign manufacturing investment led to two distinctive kinds of foreign investor operations -- one considerably more positive than even its supporters had hoped, the other considerably more negative than even its critics had feared.

1. Foreign Direct Investment in Manufacturing and Assembly: The Dark Side
The disappointing evidence emerged from cases in which host countries attempted to use foreign direct investment to spur industrialization behind trade barriers.

FDI oriented toward protected developing country markets typically resulted in plants too small to capture economies of scale in the industry, leading to inefficient operations and expensive output. When required to take on local partners, foreign investors regularly deployed technology, quality control, and other management practices that were three to ten years behind the frontier in the industry, so as to prevent their best technologies and production techniques from “leaking” in a horizontal direction to potential rivals. The obligation to purchase a specified amount of inputs locally magnified the costs of production.

In the automotive industry, for example, the import substitution strategy led to a proliferation of small assembly facilities whose output did not exceed 20,000 units per year, whereas economies of scale demanded output on the order of 150,000-225,000 per year. These boutique plants depended upon on-going trade protection to keep the plants profitable, forcing host country consumers to pay a premium of 20 to 60 percent above the international market price.

The outcome from imposing performance requirements on foreign investors for production behind host country trade barriers has not improved over time. A car assembled in 2003 at one of the mandatory joint-venture plants in the protected Vietnamese market, using 10-30 percent locally produced auto parts, cost $34,340 in comparison to $16,500 for a same-size vehicle produced under free trade-and-investment conditions in neighboring ASEAN countries. ²

Using FDI for import substitution generated local employment, but at a very high cost per job created. GM’s Hungarian affiliate assembling 15,000 OPELs behind a 22.5 percent tariff wall – before accession to the EU in 2004 forced an end to Hungary’s trade protection – created 213 jobs at a cost of more than $250,000 each, paid for by domestic car buyers.

Some host country authorities had hoped that local auto plants might generate dynamic learning among workers and managers that could turn protected infant industries into full-scale competitive operations. But the technologies and business techniques deployed in the baby plants precluded such a transition.

The parent auto firms delivered semi-knocked-down (SKD) and completely-knocked-down (CKD) “kits” to the small scale assembly plants in the host country’s protected local market. The procedures for screwing together an automobile from these car-in-a-box “kits” were -- and are today -- different from assembly procedures in world-scale sized plants, and cannot be used as building blocks for the larger operations.

Workers hold automobile bodies together with temporary jigs, and perform hand-welding, in contrast to the highly automated precision-controlled processes in full-scale production lines. High domestic content and joint venture requirements thus condemn host country operations to

using production technologies and business operations well back of the industry frontier, to produce high cost inferior products. Of seven stages in the auto production process, the first six were performed offshore during Thailand’s import substitution period, with the final (assembly) stage limited to old models – called “repeat models” – launched previously in other markets and sold for rent-making prices.\(^3\) Production at the GM kit-assembly plant in Hungary topped out at 8 vehicles per hour – in comparison to 90 vehicles per hour in full scale auto plants elsewhere -- before the GM parent decided end its relationship with the local partner and close the facility in anticipation of Hungary’s entry into the EU.

In the computer/electronics industry, the disparity between hopes and reality in adopting an import substitution strategy toward foreign investors has been even more striking.

In Latin America, joint venture and domestic content requirements generated prices for locally-produced computers 150 percent to 300 percent higher than international levels, for models three to four years (or more) behind the capabilities available in the open market. The import-substitution approach not only drained resources from individual consumers, but hurt the competitiveness of domestic firms in more advanced industrial sectors that relied upon intensive use of computers: local firms involved in petroleum exploration, aerospace, and production of industrial equipment during the protectionist period in Brazil and Mexico complained of being held back by trying to compete without access to the latest CAD-CAM technology.

Rather than placing the domestic industry at the cutting-edge of the international industry, foreign investors in the computer/electronics sector used the protected domestic content/joint venture regimes in the developing world – like their counterparts in the automotive sector -- to recycle obsolescent technology quite profitably in highly concentrated markets, without fear that their mandated local partners could acquire the capability to become rivals. Hewlett Packard and Apple used Mexico’s informatics regime to capture a second round of oligopoly rents from earlier generation technology. Chrysler acknowledged that its sub-scale operations in Mexico, prior to the country’s trade liberalization, were a “cash cow” with the highest rate of return among all the parent corporation’s plants around the world.

This new and increasingly detailed evidence about the negative characteristics of the foreign investors’ operations reinforced the doubt that was spreading about import substituting industrialization as a growth strategy. And the negative results were not limited to autos or electronics. Cost-benefit analysis of 83 foreign-owned assembly and processing projects in some 30 developing countries over more than a decade, valuing all inputs and outputs are world market prices, showed that those oriented toward protected local markets actually subtracted from host country welfare.\(^4\) The industries include industrial equipment, agribusiness, textiles, medicines, and textiles.

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pharmaceuticals, chemicals, and petrochemicals, as well as automotive equipment and electrical equipment.

Studies using cost/benefit analysis across sectors in single countries show the same negative result. Bernard Wasow examined 35 goods produced by 14 foreign-owned firms, in Kenya, within the country’s import substitution framework of the late 1980s. His measurements show that only three of the 35 generated benefits to the host economy that exceeded their costs. More than half of the 35 siphoned foreign exchange from the economy, rather than saving or earning hard currency. In the protected local setting, many of the foreign plants operated with excess capacity, but if they had expanded output their negative impact on host welfare would have been even greater.

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6 For a theoretical analysis of why trade protection, domestic content requirements, or other restraints on competition are likely to lead to a proliferation of subscale and inefficient plants, see H. Eastman and S. Stykolt, “A Model for the Study of Protected Oligopolies”, Economic Journal, 70, 1970, pp. 336-47.
2. Foreign Direct Investment in Manufacturing, Processing, and Assembly: The Bright Side

Plants that were built as part of the parents’ strategy to compete in international markets, in contrast, invariably incorporated full economies of scale, and operated with cutting-edge technologies, production techniques, and quality control procedures. To ensure maximum control and reliability of production at such plants, MNC headquarters typically eschewed joint ventures and domestic content requirements.

The best known story of the global integration of production systems, of course, traces US, European, and Japanese computer/electronics firms moving export-oriented assembly operations to Hong Kong and Singapore, then to Malaysia, Thailand, and the Philippines, and more recently to China.

The early studies of this phenomenon suggested that the parent multinationals were merely shopping around for cheap inputs from low-wage workers. By the late-1980s and early-1990s, however, it became clear that the idea of searching for cheap inputs did not do justice to the potent interaction between parent and subsidiaries in high performance electronics.

In the computer, semiconductor, and telecommunications industries, the parent corporations moved their affiliates from hand assembly of printed circuit boards, to high precision manufacturing of complex assemblies, subsystems, and entire products. In so doing, they incorporated the latest technologies, quality control procedures, and management techniques not because the host governments demanded that they do so but because their place in international markets depended upon it. The upgrading of production processes became continuous.

Plant-level studies of parent-affiliate interaction in disk drive companies, including Seagate, Read-Rite, and other international firms, showed more than a dozen engineers and managers from the wholly-owned assembly facilities in Southeast Asia arriving at MNC headquarters in the United States to work with product developers and manufacturing specialists two months prior to the introduction of each new model version, followed two weeks later by some 20-25 Malaysian or Thai operators traveling to Silicon Valley to be trained on the pilot line. Shortly before the new model launch date, all LDC members of what Seagate headquarters called its “new product transfer team” would return to the developing country plant site, accompanied by a dozen headquarters managers and engineers to set up and test the full-scale assembly line. The team membership in Malaysia or Thailand would be augmented by additional US-based experts until affiliate performance standards for high volume, low reject-level, and minimal downtime had been met.

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The search for cheap inputs from low-wage workers gave way to a much more intimate guidance by MNC headquarters over the operations of multinational integrated network.

This new paradigm – “parental supervision” – in which multinational investors place host country manufacturing facilities along the leading edge in the international industry, and keep them there, has come to characterize the globalization of industry more generally across the developing world.9

As in the electronics industry, Volkswagen designed its multinational production system, for example, so that the components in its “basic vehicle platform” (engines, axles, chassis, and gear boxes), produced at wholly-owned plants in Mexico, Brazil, Argentina, and Eastern Europe, are perfectly interchangeable, and all suppliers can introduce engineering improvements within sixteen hours of each other. Like Seagate, the Volkswagen parent upgrades the affiliates continuously – out of its own self interest – as part of the corporate strategy to compete in international markets.

Indeed the automotive sector in North America, following the trade-and-investment liberalization in NAFTA, has paralleled the electronics industry in Southeast Asia in thorough integration of production across North-South borders. Multinational auto firm exports of vehicles and parts from Mexico grew from negligible dimensions in the 1970s to some $32 billion in 2004, employing one out of every eight workers in the Mexican manufacturing sector at pay levels ($1.76-$11.42 per hour) second only to the petroleum sector. Foreign-owned assembly and parts plants in Mexico have received world-highest quality and efficiency scores from independent rating services. Relying on production sites in Mexico (and Brazil), the major US auto companies were able to counter the erosion in market share they were experiencing vis-à-vis Japanese and European producers, leading MNCs from the latter countries to match the new pattern of sourcing from Latin American plants (see the box in Section IV on NAFTA-based redesign of Ford’s best-selling F-150 truck in 2004-5).

The evidence of potent interaction between parent and affiliate within wholly-owned supply chains extends across manufacturing sectors. In a survey of 14 industries, Vijaya Ramachandran found that the transfer of technology and the interchange of managers and technicians between headquarters and subsidiary were significantly higher for wholly-owned plants than for joint ventures or licensees.10 The results were the same for metal products, chemicals, rubber, food, textiles, and medical products, as well as transport equipment and electrical goods.

International firms that organize themselves to trade intra-firm between developed and developing country affiliates differ significantly from those that do not. In an analysis of US MNC parent-affiliate relations in 49 developing countries from 1983 to 1996, Susan Feinberg and Michael Keane find that knowledge-flows, production coordination, reporting links, and


other communication channels are more extensive and more active between the affiliates and the parent, and among the affiliates themselves than firms that do not trade intra-firm. As part of what Feinberg and Keane call “deep integration”, MNC affiliates that take part in intra-firm trade generally grow faster and pay higher real wages.

The degree of “parental supervision” appears to increase as a function of the sophistication of the inputs produced by the affiliates, and of the switching costs to the parent of moving from one supplier to another. Telecommunications, semiconductors, auto parts, industrial equipment, and medical products typically have vertically integrated supply chains of wholly-owned subsidiaries for crucial components while farming out production of more standardized inputs. Garment and footwear producers rely almost exclusively upon subcontractors subjected to close inspection and supervision by – but not owned by -- the multinational buyer. In fact, the subcontracting arrangements in the garment and footwear industries resemble the “surprising” spread of contract manufacturing for industrial products, considered next.

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3. A Surprising Discovery about Backward Linkages

As for the fear that wholly-owned subsidiaries would engage only in “screwdriver” operations, the evidence showed that – whereas foreign investors were determined to prevent technology diffusion in a horizontal direction that might lead to the creation of competitors – the same was not true about technology transfer in a vertical direction. Instead the foreign firms showed, over time, that they had a strong motivation to develop supplier networks close to their assembly and processing plants. This led international investors in the first instance to insist that home country suppliers follow them into Asian and Latin American markets. But it also led the international investors and their home-country suppliers to search for low cost providers of goods and services in the host economy, generating opportunities for indigenous firms as well.

Early signs from Singapore, Hong Kong, and Malaysia showing that backward linkages were minimal, for example, gave way to evidence that international investors were sourcing more heavily from both foreign and local suppliers in the host market. In the computer, telecommunications, and semiconductor industries, foreign investors provided drawings, recommended production equipment, and jointly engineered components with indigenous firms. Orders to domestic-based suppliers for simple inputs gave way to contracts for production of printed circuit boards (PCBs), power supplies, and other subassemblies. In this process of “contract manufacturing” locally-owned firms qualified to become Original Equipment Manufacturers (OEM) in the multinational firms’ supply chains.

In the automotive sector, foreign investors in Mexico conducted production audits and taught “zero-defect” procedures to indigenous suppliers. Within five years after the multinational firms began to use Mexico as an export platform, one hundred fifteen local auto part companies had passed $1 million in sales. More than half of the thirty largest component exporters (excluding engines), were indigenous Mexican firms.

In Thailand, Archanun Kohpaiboon finds that foreign investors relying on local suppliers for components for their exports of assembled automobiles went beyond factory visits and production recommendations. Technicians from the foreign assemblers “ate and slept with local workers” to assist in reducing defect rates and dollar costs per parts-unit. By 2003, according to the Thai Automotive Industry Association, the fourteen major US, Japanese, and European automotive investors had certified 709 local firms for OEM status (287 foreign-owned, 68 joint ventures, and 354 Thai-owned), backed by 1,100 second and third tier suppliers.

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In Indonesia, American and Japanese managers described a system of regular stages through which indigenous firms could qualify to enter the foreigners’ supply-chain. First, engineers from the foreign plant would inspect local factories and suggest production modifications. Then, sample components would be forwarded to a testing facility in the home country. For those who passed, managers from the local firm would be sent to overseas training classes to learn the parent company’s procedures for inventory control, quality control, and cost accounting. Then, if small initial contracts were fulfilled on-time and within-specification, the indigenous firm would be accepted into the parent’s established network.

In some cases, the foreign investors would help successful indigenous suppliers to penetrate international markets, via exporting to sister affiliates of the investor. The Japanese investors in Indonesia reported that they would often import components from suppliers in Malaysia and Thailand that had been referred by affiliates within their corporate group located there. The goal of the Japanese managers in all three countries was to allow the suppliers to reduce costs by achieving economies of scale.

The globalization of manufacturing and assembly provided opportunities for the development of host country industries – such as machine tools – whose operations were broader than merely supplying goods and services to the original purchasers. Malaysian-owned machine tool firms grew up filling simple stamping and machining orders farmed out by the large semiconductor and telecommunications investors. These orders gave way to more complicated contracts, including joint design of machinery used in the assembly and testing of electronic systems. The owners of seven of the nine most successful Malaysian machine tool companies had worked at a foreign multinational purchaser before setting out on their own; ten percent of the workforce also had prior employment with the foreigners.

These Malaysian machine tool companies first entered export markets via sales to plants outside Malaysia owned by the parent of affiliate that first established the relationship. Within a decade, two had added sales to independent buyers in world markets, beating out machine tool companies from Germany, Japan, and Taiwan to obtain the orders. As the original Malaysian firms moved into precision tooling, they in turn subcontracted basic service orders to a new tier of smaller Malaysian machine tool suppliers.

The opening of Eastern Europe to foreign direct investment exhibits similar kinds of vertical relationships. A survey of 119 majority-owned foreign affiliates operating in the Czech Republic in 2003 showed that ninety percent of the respondents purchased inputs from at least one Czech firm, while the median multinational had a sourcing relationship with 10 Czech suppliers and a

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17 See the Box Insert entitled “Why Do Economists Have Such Difficulty in Measuring Spillovers and Externalities?” in this Section for the discussion of how to identify contributions that accrue to local firms and workers without being paid for.
multinational in the top quartile had a sourcing relationship with at least thirty. More than a tenth of respondents acquired all of their intermediates from Czech enterprises. The FDI sectors included fabricated metals, public and printing, rubber, machinery, apparel, electrical machinery, food products, textiles, non-metallic mineral products, furniture, pulp and paper, wood products, chemicals, radio, TV and communications equipment, leather, basic metals, medical equipment, motor vehicles, and other transport equipment.

As Chapter 6 in this Section points out, the expansion of vertical linkages to host country suppliers appears to vary as a function of the sophistication of local firms, the presence of business-friendly operating conditions in the host economy (including access to duty-free imports), and the length of the foreign investors’ operating experience in any given country. Chapter 6 identifies the steps developing countries can take to encourage the development of local suppliers.

The strategy of trying to build up the host country industrial base through imposing domestic content requirements on protected foreign investors, in contrast, turned out to be quite disappointing. In both Asia and Latin America, higher value-added components in the automotive sector -- such as transmissions, catalytic converters, axles, fuel injection and exhaust systems -- had economies of scale that exceeded what kit assembly plants could absorb, hindering local producers from entering into production of these components or from utilizing the most advanced processes and quality control techniques. Even relatively simple components such as windows, coils, electrical harnesses, stamped or molded plastic parts, and springs required longer production runs to be competitive. Protected from competition, local suppliers often used out-of-date technology, second hand machines, and antiquated quality assurance procedures.

In electronics, the spread of backward linkages from foreign affiliates to local firms was even more constrained than in the automotive industry. Protected local markets did not permit the scale required to farm out production of basic components like printed circuit boards, or to establish large-batch quality control techniques.

A comparison of the auto industry in South Africa and the computer industry in Mexico before-and-after each country liberalized trade-and-investment illustrates the contrast in foreign investors’ operations.

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Prior to the election of Nelson Mandela, the economic isolation of South Africa resulting from apartheid was reinforced by heavy protection for domestic industries. Local auto assembly plants, under license to foreign multinationals, turned out high-cost vehicles in limited production runs, with productivity approximately half the average at full-scale facilities in Europe or the United States, and less than half the average in Japan. Backward linkages to South African component producers yielded parts that were more expensive, less sophisticated, and not as reliable as the industry standard.

With the end of apartheid, DaimlerChrysler, Volkswagen, and BMW decided to replace the low-volume protected plants with full-scale export-oriented plants to produce right-hand models of the Mercedes-Benz C-Class coup, the VW Gulf-4 hatchback, and the BMW 3-Series sedan for sale in the UK, Australia, and Japan. A competitive position in world markets required reducing the average number of hours needed to build a car from 100 to less than 60. To accomplish this, DaimlerChrysler sent hundreds of South African workers for on-the-job training at its main-line plants in Germany, and flew in dozens of production and quality-control experts from headquarters, at a cost in the millions of dollars. The objective was to make the C-Class sedans from East London, South Africa, “every bit as good as those coming out of the plant at Bremen, Germany”.

As for component production, Ford bought out the company that had been its local partner in the earlier protected market, and built a wholly-owned world production center for one line of engines. Drawing on South Africa’s internal supply of platinum and palladium, other auto-parts companies set up plants to produce catalytic converters for worldwide consumption (reaching ten percent of entire global output by 2002).

In the Mexican computer industry, as recorded earlier, joint venture and domestic content requirements led Hewlett-Packard, Apple, Compaq and other investors to assemble models three

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to four years behind the industry standards, which they sold in the protected local market for prices 150 percent to 300 percent higher than world prices.

To meet domestic content requirements, the foreign computer investors lined up local companies to supply orders for a few thousand cables, resistors, keyboards, cabinets, and other passive components each year. With such tiny purchases, local companies used outdated materials like fiberglass and aluminum for computer cases in place of newer, lighter composite materials, and utilized rather primitive assembly techniques like hand-soldering in place of high-volume, high-precision production runs.

Once Mexico abandoned its mandatory joint venture-domestic content informatics policy, it achieved results not unlike those previously seen in Singapore, Malaysia, and Thailand. The Mexican decision to allow IBM to establish a wholly-owned plant dedicated to exporting components and products into the parent’s Western Hemisphere sourcing network stimulated HP and Apple to follow in IBM’s footsteps, building new full-scale production sites for export as well as domestic sales.

Not typically thought of as major player in high performance electronics, Mexico saw a “Little Silicon Valley” grow up around the educational-intensive region near Guadalajara. US investors (Intel and 3Com, as well as IBM and Hewlett-Packard) led the way, bringing their component suppliers with them – component suppliers that included contract manufacturers like Flextronics and NatSteel Electronics from Southeast Asia.

With the trade and investment liberalization associated with NAFTA, both the absolute amounts and the percentage of components produced domestically in the Mexican computer industry – as in Southeast Asia – increased. By 2000 the Guadalajara cluster reached 125 companies – including a growing number of indigenous Mexican-owned companies – employing 90,000 workers.

Chapter 7 in this Section picks up the story of how Mexico has been trying to meet the competition from China as a site for labor-intensive assembly plants.

End Box Insert

The contrast in performance between foreign plants integrated into the supply networks of the parent and foreign plants prevented by domestic content requirements and mandatory joint venture requirements from being so integrated is clear from the Mexican and South African cases above. But an understanding about the detrimental impact of “performance requirements” needs to spread from the community of development strategists to the ranks of trade negotiators. At the Hong Kong Ministerial Conference in December 2005, developing country representatives rewrote the terms of the TRIMs (Trade Related Investment Measures) Agreement that had banned the imposition of domestic content requirements. Developing countries will now be free to demand that foreign investors meet old and new kinds of performance requirements for at
least seven more years, and possibly until 2020.\textsuperscript{20} As seen above, governments that actually pursue this strategy are sorely misguided about how foreign direct investment can best contribute to host country growth and welfare.

\textsuperscript{20} World Trade Organization, \textit{Ministerial Declaration}, Annex F (84), December 18, 2005.
4. New Methods to Measure the Impact of FDI on Development: From Improving Efficiency in the Host Economy to Transforming the Production Frontier of Country

The preceding evidence suggests that the impact of foreign direct investment on the host economy is larger than what has conventionally been assumed, both negative and positive.

On the negative side, Chapter 1 illustrated how FDI operations in protected host country markets almost always suffer from various inefficiencies. Their high cost output penalizes both users and consumers. As the cost-benefit measurements gathered by Wells, Encarnation, and Wasow show, FDI that is sheltered from international competition typically subtracts from host country welfare. Boutique petrochemical plants, knocked-down car-in-a-box construction works, last-generation computer-kit assembly operations, and carefully sheltered sugar mills waste host country resources, and impede growth.

The adverse effects are greater than what is traditionally called “tariff jumping” FDI. This latter phenomenon envisions multinational corporations building full-scale, cutting-edge plants in the host country (like Japanese auto plants in the United States in the 1980s), essentially equivalent to what the parent operates in the home market. Import-substituting FDI in the developing world in contrast – as shown earlier – usually involves markedly different production processes in conspicuously small and uneconomical plants.

The search for rents generated in markets sheltered from international competition not only diverts investment from more productive areas. Over time, foreign investors may actually siphon off capital, as they send excess profits abroad, in what Richard Brecher and Carlos Diaz Alejandro labeled a process of “immiserizing growth”.

To anticipate a discovery that will be presented in the concluding Section of this volume, it will be appalling to find that nineteen OECD countries – not least the United States – nonetheless continue today to support and protect the establishment of such damaging FDI projects in developing countries, as do multilateral agencies like the Multilateral Investment Guarantee Agency (MIGA) of the World Bank group.

On the positive side, there has been a revolution over the past decade in how to conceptualize the contribution that FDI can make to host country development.

There are many ways in which foreign direct investment may benefit a host country when the international firms operate under more competitive conditions.

The earliest – and most primitive – approach to measuring the impact of foreign direct investment has been to view foreign firms primarily as providers of capital. For a poor country whose principal development constraint is lack of capital, foreign firms may add to the host

country capital stock, and through this “capital deepening” raise the level of output. Their local operations may then provide goods and services that are cheaper and of higher quality than previously available, enhancing host country consumer welfare and making host country firms more competitive.

External capital that comes in the form of foreign direct investment has the advantage of being less volatile than other kinds of capital movements. The degree of variation in foreign direct investment flows has proved to be substantially lower than bank loans and portfolio investments. And, in the midst of financial crises, foreign investors are unable to uproot plants and factories. The World Bank concludes that reliance on FDI not only helps sustain the host economy in general, but poor members of society in particular, since the poor suffer disproportionately during currency upheavals.

Besides providing more stability, foreign firms are also often better equipped than local companies to take advantage of the increased competitiveness of host country production sites that results when a currency is devalued. During the Indonesian financial crisis of 1997-98, for example, Garrick Blalock and Paul Gertler found that foreign investors enjoyed preferential access to external sources of capital, both for themselves and for their suppliers, during the subsequent local credit crunch. In contrast to domestic exporters with no foreign links, the affiliates of foreign multinationals were able to expand production and increase exports after the massive Indonesian devaluation. The foreign presence offered a kind of liquidity insurance that hastened the host country economic recovery.

But the provision of capital is only the most narrow way to envision the contribution of FDI to host country development. A more comprehensive way to appreciate what foreign investors bring, as Paul Romer was the first to argue, is to view their contribution as an injection of “new ideas” about what kinds of activities are possible for local factors of production to perform.

For Romer, “new ideas” refer not just to novel technologies, but to the whole integrated package embodied in foreign investor operations. The principal value of foreign direct investment comes from opening the host economy to the global store of R&D; to the leading production processes, quality control procedures, and marketing techniques known around the world; to the cutting edge of competitive performance in international markets.

Romer’s initial example came from Mauritius, a country initially so poor that its growth experience deserves special examination in Section II of this volume.

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Mauritius seemed destined to remain a poverty-stricken nation, dependent upon agriculture for almost all economic activity, Romer observed, until foreign garment investors began to arrive in the early 1980s. What the foreigners brought was new “ideas” about managing clothing production and navigating the complex import quota system of the developed world. Much of the modest amounts of capital required by these foreign-owned enterprises, he noted, was actually raised locally, and the weaving and sewing equipment was readily available in world market. What the foreigners added was the orchestration of the production-and-marketing process that purely indigenous firms were initially incapable of achieving on their own.

The case study of Mauritius in Section II shows how foreign investment turned the economy into one of the most powerful new entrants into the world economy, with manufactured exports passing the $1 billion mark by 2005. Initially dominated by foreign owners, the export of garments and then other light industries began to be mastered by indigenous firms. Often founded by managers trained in the foreign plants and employing workers lured from those plants, local companies accounted by 1995 for fifty percent of the total equity capital involved in export processing.

FDI-led growth, concludes Romer, fundamentally alters the production possibility frontier of the host economy.

What is the most accurate way to measure the contribution that this FDI package-of-technology-and-management -- including “new ideas” of how to deploy local resources -- brings to host country development?

The traditional method of assessing the benefits from foreign investor activities, Romer points out, is to calculate the loss in national output that would occur if a government were to impose a tariff or a tax on the firms that operate in the economy. The estimate of the contribution from foreign direct investors is the inverse of the cost to the economy of distorting the firms’ operations with a tax or a tariff. That is, the gain from allowing foreign investors to operate is the increase in efficiency that comes from not imposing the tax or the tariff. The result is relatively small, a fraction of national income that varies with the square of the tax or tariff rate.

But this approach implicitly assumes that all of the relevant productive activities already exist in a developing country, and that the essence of economic development is just to do more of the things that the economy already does, or to do them more efficiently. What is needed, argues Romer, is to measure the welfare gains when new activities employing new techniques -- “imported” via FDI -- are launched and tried out in the host economy, or the welfare losses when they are not.

This change in perspective -- obvious once pointed out -- is not a minor modification in how to measure the impact of foreign direct investment on development. The welfare gains, or welfare losses, from this second calculation -- that lets the set of goods, services, and productive techniques vary with the entry of foreign investors -- is ten to twenty times greater than the first.

This large differential derives not from the effect of changes in the allocation of resources among sectors already represented, but from taking into account the introduction of new industry
segments and the deployment of novel production processes, capital goods, intermediate inputs, and management procedures.

The notion of FDI as a transmission belt for technology and cutting-edge management techniques is a central component of contemporary models of dynamic comparative advantage.²⁴

Costa Rica’s experience with foreign investors provides a thumb-nail sketch of how comparative advantage moves from a static to a dynamic phenomenon via the injection of FDI.

What is the Costa Rica’s comparative advantage in the world economy?

Thirty years ago, Costa Rica had, like Mauritius, an agricultural economy that specialized in coffee and bananas. Twenty years ago, thanks to a first wave of foreign direct investment, Costa Rica added production of garments and footwear to its specialization in coffee and bananas. Today, bolstered by a second wave of foreign direct investment – and the interaction between the multinationals in this second wave and an increasingly skilled local workforce -- Costa Rica boasts production of microprocessors, medical equipment, electronic devices, data processing, and business services in addition to production of coffee, bananas, garments, and footwear, paying 20-52 percent more than local companies and generating $5 billion per year in exports.

How Costa Rica accomplished this merits more detailed treatment later in this Section (see also the chapter on “Wages Paid to MNC Workers and Subcontractors” in Section II).

For now, the Costa Rica case shows how successive waves of foreign direct investment transformed the development trajectory of the host economy. With the globalization of industry via FDI, it is no longer possible to consider that a country’s initial factor endowment consigns the economy to a given position within the international system. Rather, the result of trade-and-investment moving together can aptly be described -- in a positive rather than a pejorative sense -- with the popular phrase “trade on steroids”.

What is noteworthy – in light of the evidence introduced earlier – is that this new approach to evaluating the impact of FDI on development is still far too static. However much Romer and other specialists in what has come to be called “endogenous growth theory” improve upon conventional measurement techniques, the resulting estimates are even then clearly too low. They leave out a central feature of the foreign investment story observed at the beginning of this Section. Foreign investors not only introduce new activities into the host economy, but continuously upgrade the technologies, management techniques, and quality control procedures.

of their affiliates to keep their sourcing networks at the competitive frontier in the international industry.
Why Do Economists Have Such Difficulty in Measuring Spillovers and Externalities?

Spillovers and positive externalities are benefits to domestic firms, workers, and consumers beyond what the foreign investors are paid to provide. The search for externalities and spillovers provides a picture of the extent to which the very presence of foreign firms diffuses new skills, technologies, and capabilities throughout the host economy.

It is possible to imagine – in the abstract -- that foreign investors enter a host economy and train local managers and workers who never leave the foreign-owned firms, set up operations without any local firms copying their use of machinery or their management techniques, and create supply chains with indigenous companies that learn nothing new from the relationship, enjoy no scale effects, or – if they do –use the novel skills to sell exclusively to the foreign subsidiaries who capture all the benefits that result. These foreign investors would still have value for the host economy through adding to the local capital stock, and enhancing productivity in use of host resources, and host authorities would be justified in eliminating restrictions and opening borders to FDI to obtain this value. But the foreign firms – in this hypothetical exercise -- would provide no spillovers or externalities to the host economy.

As reported earlier in this Section, firm surveys and industry case studies provide abundant evidence of various kinds of spillovers and externalities – workers and managers who do leave foreign-owned affiliates and use their skills to set up their own firms, suppliers that do receive instruction and assistance from foreign-owned buyers, local companies that do copy the production processes and management techniques of foreign-owned rivals.

The evidence that comes from these firm surveys and industry case studies is typically referred to as “anecdotal” as if the next observation might invalidate all the previous ones. But these sources of data can be organized across industries, across time periods, and across countries so as to avoid selection-bias and offer assurance that there are consistent patterns of outcome.\(^{25}\) With careful organization, firm surveys and industry case studies can provide confidence that one or two random observations to the contrary will not be sufficient to overturn the results.\(^{26}\)

\(^{25}\) This is the way the data are organized in Theodore H. Moran, “How Does Foreign Direct Investment Affect Host Country Development: Using Industry Case Studies to Make Reliable Generalization”, in *Does Foreign Direct Investment Promote Development?* op. cit..

Using econometric techniques to investigate externalities and spillovers poses complex challenges.

The recognition that FDI in manufacturing and assembly comes in clearly positive -- and distinctly negative -- forms helps explain why the first generation of econometric studies was unable to make much sense of how foreign direct investment affected the host economy. Econometric analysis that mixes data from import-substitution-FDI with export-oriented-FDI, data from foreign investors free to source from wherever they wish with data from foreign investors operating with domestic content requirements, and data from foreign investors forced to operate as minority shareholders with data from foreign investors enjoying whole- or majority-ownership cannot help but show jumbled results.27

Even when the distorted and inefficient results from heavily protected foreign investor operations are kept separate, using econometric techniques to identify and measure externalities and spillovers is still fraught with difficulty.

Externalities and spillovers may extend in a horizontal direction to rival firms in the same industry, and in a vertical direction backward to supplier firms or forward to buyer firms.

In the horizontal direction, externalities and spillovers may take the form of the movement of workers and managers that have been trained by the foreigners into firms that are, or become, rivals to the foreigners themselves. Horizontal externalities and spillovers may also take the form of demonstration of new technologies and management or marketing techniques, along with competitive pressures for indigenous participants in the industry to adopt them.

In the horizontal direction, the standard econometric procedure has been to investigate how the total factor productivity of local firms28 varies as a function of the presence of foreign direct investment in the sector. But a positive correlation between foreign direct investment and the performance of other firms in the industry does not demonstrate whether FDI raises the productivity of the other firms – perhaps by demonstrating new technologies or management techniques, and by generating competitive pressures of the other firms to adopt them -- or whether the foreign firms are simply attracted to sectors or locations where others are already more productive.

So, a next step might be to investigate how the total factor productivity of local firms changes as a function of increases in the presence of foreign direct investment in the sector. But a positive correlation between increases in foreign direct investment and improvement in the performance of local firms does not eliminate the possibility that there is some “external” factor – such as an

27 As can be seen in Brian J. Aitken and Ann E. Harrison, “Do Domestic Firms Benefit from Direct Foreign Investment? Evidence from Venezuela”, American Economic Review 89, no. 3 (June), pp. 605-18.

28 For the evidence on wage spillovers and externalities, see the insert “How Much Do Multinationals Pay Local Workers?” in Section II.
improvement in regulatory practices – that accounts for both the rising level of foreign direct investment and the rising total factor productivity of other firms in the sector or location.

Moreover, as Beata Smarzynska Javorcik and Mariana Spatareanu point out, the entry of a foreign investor is likely to have two overlapping impacts in a horizontal direction at the same time -- on the one hand, enhancing the performance of local firms through the spread of knowledge and personnel, and, on the other hand, damaging the results achieved by local firms through more intense competitive pressures. Surveying managers of local firms in the Czech Republic and Latvia, they found that almost a quarter of respondents in the former and fifteen percent in the latter learned about new technologies as a result of a growing foreign presence. Twelve percent of the Czech firms and nine percent of the Latvian firms reported that they discovered new marketing possibilities via the spread of foreign investors. At the same time, thirty percent of the firms reported losing market share as a result of the rising competition from foreign investors in their sector.

Econometric studies that simply measure changes in total factor productivity of domestic companies in sectors with an increasing proportion of foreign participants, Javorcik and Spatareanu argue, are not going to be able to unravel these two disparate effects. To measure horizontal spillovers and externalities, econometric researchers will have to introduce controls for the level of competition, and for the movement of labor and technology between foreign and domestic firms.

Finally, the investigation of horizontal spillovers and externalities, as Robert Lipsey and Frederik Sjoholm note, requires an assessment of the net effect on the use of host country resources – an analytic point often lost in the concern that FDI might harm local companies or “crowd out” (diminish) domestic investment. With rising competition from foreign investors it is logical to expect that the least efficient local firms would experience lower profits, and some might exit the industry altogether. But if average productivity across foreign-owned and domestically-owned firms rises, the outcome, argue Lipsey and Sjoholm, should be considered favorable for the host economy.

Overall, however, Grace MiaoWang has discovered that foreign investment tends to crowd in, rather than crowd out, investment in developing countries. Over time, the cumulative effect of FDI is positive in stimulating an increase in domestic investment.

Turning to the impact of FDI in a vertical direction, determining with precision exactly which spillovers qualify as genuine externalities is no less tricky.

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Once again, firm surveys and industry case studies document various kinds of direct assistance as foreign investors develop local supplier or distribution networks. In the survey of 119 majority-owned foreign affiliates operating in the Czech Republic in 2003, noted earlier, by Javorcik and Spatareanu, one-fifth of the foreign investors reported providing some type of direct support to the Czech companies they bought inputs from. The most frequent form of assistance was advance payment or other financing. Second was employee training. Third was help with quality control. Other types of assistance included providing production technology, lending machinery and helping to organize the production line, aiding with financial planning and business strategy, and introducing the firm to foreign buyers.

These forms of assistance clearly count as externalities. More ambiguous is the stimulus for self-improvement in host firm performance that derives simply from the possibility of becoming a supplier to foreign multinationals. MNCs frequently demand that local firms acquire ISO 9000 certification of high quality standards to qualify to become suppliers. Forty percent of the Czech companies with ISO 9000 certification in the Javorcik-Spatareanu survey reported that the desire to become a supplier to the multinationals – to enjoy the MNCs’ more reliable payment systems and attractive external marketing relationships – motivated them to acquire the ISO 9000 qualification. While the foreign investors did not consider the ISO requirement to be a form of assistance, the process of becoming certified clearly led the Czech firms to overcome operational shortcomings. Javorcik and Spatareanu call this a “positive productivity shock”.

Using econometric techniques to identify and measure spillovers and externalities in the vertical direction faces the same problems as in the horizontal. A correlation between the presence of foreign investors and higher total factor productivity in upstream or downstream local firms might occur because the foreigners were attracted to regions or sectors where local firms exhibited superior performance. A correlation between a growing presence of foreign investment and improvement in total factor productivity in upstream or downstream local firms might be due to factors that both attract foreign investors and also raise productivity in domestic firms simultaneously, so that inferring a causal connection would be incorrect.

These challenges of introducing the required controls are not insurmountable, however, as Garrick Blalock and Paul Gertler demonstrate. Using data on manufacturing establishments in Indonesia that have been conscientiously collected by region since 1988, they show how it is possible to be successful in isolating the relationship between changes in FDI and changes in domestic firm behavior without allowing the intrusion of other factors that might affect both FDI and domestic firm behavior simultaneously.

When the analysis is done in this way, they find that the independent effect of FDI in augmenting the productivity of local Indonesian suppliers is large and significant. The apparent transfer of technology and other business practices from the foreign investors to local suppliers resulted in lower prices, increased output, higher profitability, and increased entry in the supplier market. The lower prices of the suppliers, in turn, led to lower prices, increased output, higher profitability, and increased entry throughout the Indonesia host economy.

What are the implications of these findings about spillovers and externalities for developing country strategy to attract foreign direct investment? Does the potential for the host economy to

capture benefits greater than what the foreign firms are paid to supply justify the escalating expenditure of host country resources to draw foreign investors into the domestic economy?

The design of an effective host country strategy to attract foreign investment requires more subtlety than simply deciding whether to thrust subsidies and tax breaks into the hands of foreign corporations, or not.

To understand why must begin with an appreciation of the transformation that has taken place in techniques of investment promotion, presented next.

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5. **Shifting From the Old Model to the New Model of Investment Promotion: The Complicated Question of Providing Investment Incentives**

The growing appreciation of the positive benefits from having plants integrated into multinational sourcing networks, and of the negative burdens from having plants oriented to protected local markets, has altered developing country strategies for attracting foreign investors in fundamental ways.

As long as foreign investors were seen primarily as a vehicle for import-substituting industrialization, the agencies charged with dealing with foreign investors could wait for foreigners interested in earning high profits in markets sheltered from international competition to show up, screen their proposals, and then levy performance requirements upon them as a condition for giving them access to oligopoly rents.

Attracting export-oriented foreign investments proved to be much more difficult, however, especially when the proposed operations were obliged to make an intimate contribution to the parent’s competitive strategy.

When considering whether to build a plant whose output would be incorporated into a tightly-knit supply chain, multinational corporations showed themselves to be risk-averse and hesitant about making capital-intensive “irreversible commitments” upon which their standing in international markets would depend. Their behavior was quite at odds with the popular image of multinational corporations scanning the world and pouncing eagerly upon each and every possibly-profitable opportunity. Not only did they insist upon the right to establish wholly-owned or majority-owned subsidiaries free from domestic content requirements, but – even when these were proffered -- they were cautious about setting up affiliates in new and untried locales.

This changed the conceptualization of what was required for investment promotion profoundly. In place of passively waiting for the eager profit-seekers to pound on the door, the new task for host authorities became to demonstrate that their country was superior to alternatives elsewhere when the target investors could not know for sure until they actually had tried the site out.

Instead of simply letting markets work on their own, attracting foreign direct investment has required a deliberate four-part strategy – three parts well-justified, the fourth more questionable. Each involves spending public resources.

The first step is to begin to create a “good investment climate” for the foreign firms to work in.

To accomplish this, the difficulties might at first appear to be overwhelming. The list of what the multinational corporate community considers the ingredients for a “good investment climate” is long and demanding: low inflation; equilibrium exchange rates; steady economic growth;

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reliable infrastructure; high literacy rates; liberalized trade; little ethnic tension; minimal corruption; stable and transparent political institutions and procedures; independent and capable judicial systems; and – more recently -- low incidence of HIV-AIDS, malaria, and other infectious diseases, and extensive access to the internet.  

But, as the next Section – on foreign investment promotion in the poorest states – will demonstrate, it has not been necessary to wait until all the elements of production-friendly reform are present to launch a successful effort to attract foreign investors. As described there, the beginnings of macro, micro, and institutional reform (realistic exchange rates, low inflation, respect for contracts and property rights, declining incidence of bribes and kickbacks) – backed by serviceable infrastructure – have been sufficient to get foreign investment-led growth started.

The second component of the FDI attraction strategy is to overcome imperfections and asymmetries in the provision of information about production possibilities in any given host economy. International investors do not have instantly accessible, accurate, up-to-date, and comparable data on alternative production sites in Asia, Latin America, Africa, and elsewhere in the developing world. Countries that have been successful in attracting foreign direct investment have had to set up modernly-equipped investment promotion agencies to “market the country” – in the words of the World Bank’s Foreign Investment Advisory Service – preparing not just glossy advertisements but detailed information as demanded by engineering, legal, and financial executives at corporate headquarters in the developed world. The agencies are staffed with above-average-trained-and-compensated professionals, backed with websites containing the latest laws and regulations, linked to action officers in key ministries and to current investors (“satisfied customers”).

In place of cumbersome, highly discretionary “screening” of investment proposals, these “one-stop-shop” investment promotion agencies ideally are empowered to make the approval of investment projects as rapid, automatic, and transparent as possible. Since one-stop shops encroach upon the prerogatives of powerful ministries (Economics, Treasury, Environment, Immigration) – and may have to duplicate the expertise of such ministries – investment promotion agencies have not been the easiest organizations to launch effectively. One promising approach has been to have the agencies house staff from the relevant ministries whose duties are to troubleshoot investor-ministry relations, with FDI approvals automatic if the ministry does not lodge a substantive objection within a (short) specified time period. In practice, the objective must be a genuine “one-stop-shop”, not a “one-more-stop-shop”.

The third component of the FDI attraction strategy is to overcome anxieties of risk-averse investors who have to make a large capital expenditure without being able to know until they

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“test drive” the proposed facility whether they will be “stuck with a lemon”.34 This has typically required direct expenditures of host government funds – on infrastructure, or on vocational training programs, for example – that help reduce the uncertainty surrounding the performance of foreign plants, especially the first foreign plants in any given sector.

The fourth – and more questionable – component of the FDI attraction strategy has been to “close the deal” by providing tax breaks and other subsidies directly to the investor.

How a prospective host country can best integrate these three – or four – components into a coherent FDI attraction strategy is tricky.

The Foreign Investment Advisory Service of the World Bank Group points to Costa Rica -- the country whose evolution in using FDI illustrated the meaning of dynamic comparative advantage earlier -- as the “model” for other countries to replicate in designing a successful contemporary investment promotion strategy.

A close look at this well-researched country case study shows that would-be hosts cannot simply expect international markets to work on their own. Costa Rica had to work through all four steps – making up-front public expenditures all along the way – with considerably uncertainty about whether its investment promotion strategy would pay off.

Like the other countries that will be considered in Section II of this volume, Costa Rica initially had little luck in attracting foreign investors until the government undertook sound macroeconomic policies in the mid-1980s, bringing inflation under control and adopting a realistic exchange rate. Even then, early efforts to attract investors to Export Processing Zones (EPZs) that were located where the lowest-wage workers could be found -- in the poorest regions of the country -- did not flourish. A change of policy to allow EPZs in industrial parks near the capital, where infrastructure was more adequate, produced better results. By the late 1980’s Costa Rica managed to attract some $368 million in investment, generating 37,000 jobs, concentrated almost exclusively in the garment industry.

Fearing that rising domestic wages would erode the country’s ability to compete in labor-intensive manufacturing, the country restructured its investment promotion agency, CINDE (la Coalicion Costaricense de Initiativas para el Desarrollo), in 1992, with the objective of diversifying the foreign investor base toward higher-skilled operations. The agency researched the needs of companies in semiconductors, medical equipment, pharmaceuticals, and business services, and began drawing up proposals suited to the particular needs of these sectors.

CINDE advertised the extent to which Costa Rica -- unusual for Latin America -- was directing the country’s national educational programs toward the basic technical skills needed by these industries, installing computer labs in elementary and middle schools, for example, and expanding vocational high school and public junior colleges.

But, without any previous investors in these industries, it was not easy to place the country on the radar screen of potential entrants.

The Intel corporation was the country’s most prized target. But Costa Rica was not even on Intel’s “long list” of possible production sites for a proposed new semiconductor plant. Despite what Debra Spar calls “assiduous” campaigning, it took CINDE two years to convince Intel even to approve a visit to corporate headquarters in Silicon Valley.\(^{35}\)

Concerned about bottlenecks that might reduce the company’s “lead time over rivals”, Intel stipulated that any country that wanted to be a finalist in the competition among plant sites must have reliable infrastructure and an adequate supply of appropriately-trained workers. To meet infrastructure requirements, CINDE obtained Presidential approval to accelerate construction of a new cargo terminal at the national airport, and to dedicate a new substation of the state-owned electric utility to meet Intel’s needs. To assure the availability of appropriately-trained workers, CINDE proposed a joint program between Intel’s human resource executives, the Ministry of Education, and the country’s vocational training institutes to prepare workers with skills needed at a semiconductor plant.

Costa Rica made it onto Intel’s “short list”.

To close the deal, Intel demanded tax treatment equal to what was available at the other “short list” contestants (Indonesia, Thailand, Brazil, Chile, and Mexico). CINDE complied, offering full exemption from income taxes for the first eight years of operation, and a 50 percent exemption for the next four.

Backed by the personal involvement of the President of the Republic, CINDE moved from feasibility study to completion of negotiations within a single year, gaining Intel’s commitment to a $300 million semiconductor assembly and testing facility in 1996.

Although Costa Rican officials admitted that during the negotiations they had only an intuitive appreciation of the market failures they had to overcome and the externalities they might acquire,\(^{36}\) the rationale for foreign investment promotion of the kind CINDE engaged in can be seen in hindsight to be quite defensible. Absent the expenditure of host country resources on an energetic effort to “market the country”, Costa Rica faced what Dani Rodrik and Ricardo Hausmann call negative “informational externalities” that the market does not solve on its own.\(^{37}\) Absent the expenditure of host country resources to reduce foreign investor anxieties about the most likely sources of production trouble (airport delays, power failures, skilled-manpower shortages), Costa Rica would likely have lost the sophisticated operations, high paying jobs, and spillovers the Intel plant promised.


But at the moment when the investment agreement was signed the only sure benefits for the country came from the new $700 million in annual semiconductor exports, and the employment of some 3500 workers who received wages averaging 52 percent higher than other manufacturing jobs ($3.36 per hour at Intel in 1997 dollars, in comparison to $2.21 elsewhere). It was impossible to know for certain that genuine externalities would emerge, that workers and managers that received training at Intel would eventually leave to set up their own operations with knowledge acquired at the semiconductor affiliate, selling services and inputs first to Intel and then to other local buyers.38

Nor was it possible to predict that there would be what turned out to be a powerful “signaling” or “demonstration effect” from securing the Intel plant. In the three years after the arrival of Intel, Costa Rica tripled its stock of foreign investment, to a total of $1.3 billion, with annual exports of $3.3 billion that propelled the country to surpass Chile as the most export-intensive economy in Latin America. A survey of sixty-one multinationals with plants in Costa Rica revealed that 72 percent (thirteen in medical devices, three in business services, and nine in other sectors, as well as thirty-six in electronics) considered the Intel investment as important to their own locational decision.39 The backward linkages and spillovers from Motorola, Abbot Laboratories, Baxter Healthcare, Procter & Gamble, FedEx emerged slowly, but grew over time. By the beginning of 2005, total zone exports exceeded $5.3 billion.

At the end of the day, the Costa Rican case illustrates the insight seen earlier in the work of Paul Romer that the expenditure of resources to attract Intel provided an “access ticket” to the greater pool of technology, management practices, and quality control procedures already present in developed country economies.

But, does the Costa Rican experience demonstrate that the rising levels of tax breaks and incentives that are being offered to multinational investors around the world are justified?

In the Costa Rican case, it may be that a careful appraisal of the externalities and spillovers from the foreign investor base outweigh the expenditure of foregone tax revenues. But whether this will always be the outcome for every country is quite problematic. And—even when the benefits do outweigh the costs—Section V of this volume will argue that there is a need to consider whether tax holidays and other subsidies might better be controlled and capped on an international basis, to curb an escalation in revenue-giveaways that increasingly affects developing and developed countries alike.


Those host country resources that are available to be spend on FDI promotion might then be better allocated to improving the overall business climate, and providing infrastructure and vocational training improvements whose benefits are likely to pervade the economy more generally.

While CINDE is held up as an ideal for emulation by other developing countries, the Costa Rican experience was not unique. Studies commissioned by the Foreign Investment Advisory Service of the World Bank Group show that the “pro-active” one-stop-shop approach generates a statistically significant return for the prospective host country: for every dollar spent on investment promotion of this kind, the host received a stream of social benefits with a net present value of more than four dollars. Flows of FDI increase by about 0.25 percent for every 1 percent increase in the budget of the Investment Promotion Agency (IPA), with the impact magnified twice-over for countries with more favorable basic investment climates in comparison to those with less favorable.\(^{40}\)

The creation and maintenance of investment promotion agencies is not cheap, however. The annual budget for the IPA in Costa Rica is $11 million, in the Dominican Republic $9 million, in Mauritius $3 million. Richer countries spend even more: $15 million per year for Malaysia, $45 million for Singapore, and $41 million for Ireland.

Sections II and V will recommend that assistance to poorer developing countries in setting up, staffing, and maintaining up-to-date Investment Promotion Agencies – as well as help in creating a favorable investment climate, and providing reliable infrastructure and vocational training programs -- is a primate candidate for developed country aid.

Individual investment promotion agencies have explored variations on the basic pro-active, one-stop-shop model. Thailand, for example, has targeted not just new “prime” investors but also the prime investors’ suppliers in the home country. The Thai Investment Board created a cadre of Japanese-speaking investment promotion officers whose job is to visit the smaller and less internationally-experienced members of industrial “production clubs” throughout Japan, arranging visits to Thai industrial parks without a need for the participants to speak either English or Thai.

In the Philippines and the Dominican Republic, private developers of Export Processing Zones and industrial parks became an important complement to the work of investment promotion agencies. The use of private operators to create and manage EPZs and Free Trade Zones had initially been judged to be an unpromising strategy among experts in investment promotion. But the evidence soon demonstrated that the self-interest of the developers in recruiting fee-paying investors (frequently from the home country of the developer), and in assuring levels of service

that kept investors in a given zone satisfied and expanding operations, overlapped quite well with the goals of the host country. By offering the housing, transport, security, health care and day care facilities needed to ensure a stable and productive workforce – and to suit the corporate “image” of the more sophisticated zone parent companies -- private zone developers were able to charge fees three times higher than what could be collected in public zones. At the same time, some contemporary EPZ contracts allow for a fee-rebate if the Zone manager – public or private – fails to deliver specified support services, such as uninterrupted electricity or transportation. The objective is less to compensate zone investors than to provide incentives for efficient zone operation.

\footnote{Yung Whee Rhee, Katharina Katterback, and Jeanette While, \textit{Free Trade Zones in Export Strategies}, \textit{op. cit.}}
6. Expanding Backward Linkages from Foreign Investors to Indigenous Firms

The discovery that multinationals trying to build up a low-cost reliable global production network have an interest in sharing production technology and quality-control techniques in a vertical direction with LDC suppliers offers a significant new dimension to the relationship between FDI and host country development.

What have been the essential ingredients for those countries that have been able to expand backward linkages from foreign investors to indigenous firms?

The most important finding is the most obvious: the growth of a host country industrial base filled with suppliers to the affiliates of multinational corporations depends upon allowing indigenous firms being to partake of the same business-friendly conditions as the foreign investors. Indigenous companies cannot tolerate an adverse operating environment any better than the foreign firms. They too need a stable macroeconomic setting, with low inflation and realistic exchange rates. They too need dependable infrastructure, low levels of red-tape, crime, and corruption. They too need a reasonably reliable legal and regulatory environment, clear land title, and access to duty-free inputs. They too need reasonably skilled workers, technicians, engineers, and managers. Indeed, led by benchmarking of those critical conditions that affect firm performance by the World Bank, the domestic business climate has come to be understood as a key public good that conditions the evolution of a country’s comparative advantage.

An effective strategy to build up supplier networks and backward linkages form multinational investors to local firms is intrinsically linked to a need for progressively greater trade liberalization, as well as other business-friendly improvements. A danger associated with the creation of Export Processing Zones, or Free Trade Zones, is that the focus on narrow economic platforms will become a substitute for broader reform, or an excuse not to undertake broader reform. The result may be to trap the economy in a suboptimal equilibrium, held in place by those special interests that profit from on-going trade protection or other non-competitive domestic economic conditions.

These components of a good investment climate are necessary to allow an energetic national business community to emerge and gain experience in meeting standards of quality and price required by open markets, and in taking risks to achieve success, rather than relying on favors to protect themselves from competition. Some countries – like Malaysia and Thailand – established secondary industrial zones that were dedicated to the cultivation of local suppliers of goods and services, located adjacent to the FDI Export Processing Zones. But these cannot substitute for more comprehensive improvement in the climate for doing business throughout the country.

Improvement in the host country investment climate needs to be accompanied by a domestic banking system that is able to provide competitive financing to local businesses. In Latvia and the Czech Republic, multinational investors listed credit constraints faced by local companies as a principal factor preventing them from finding more indigenous sources of inputs.

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consistently point to the high cost and general unavailability of local financing as important obstacles to the operation and growth of private firms in Africa.\(^{44}\)

Beyond generic approaches to improving the investment climate, some governments have been able to set up effective “vendor development” programs. The key is to use foreign investors as talent scouts to sort through the potential local supplier base, and invite the most promising local firms to participate in management, quality control, and production-planning sessions within the foreign subsidiary. The foreign investors then recommend to the local participants what equipment, machinery, and training are needed to raise local performance to competitive supplier standards, and offer a purchase contract as financial backing for the recommended expenditures.

Singapore’s Economic Development Board, for example, subsidized the salary of an engineer or manager within individual foreign affiliates for two to three years to select and assist indigenous firms to become suppliers.\(^{45}\) Productivity of firms selected rose by an average of 17 percent in the early years after the formation of the relationship, and value-added per worker by 14 percent.

The objective is for the host country to apply light-handed manipulation of the foreign investors’ own self-interest in finding low-cost, reliable suppliers, not to impose onerous requirements to meet domestic content and technology transfer mandates. The process must be competitive and transparent enough to avoid the ever-present danger of cronyism to reward privileged host country firms.


Does Korea Provide an “Alternative Model” for Creating High Tech National Companies?

Following in the tradition of Japan, Korea is frequently mentioned as an “alternative model” – excluding foreign direct investment and relying on licenses instead – to create high tech national champions like Samsung. The implication is that contemporary developing countries – China, for example – might use official policy to force technology transfer to indigenous companies while refusing to grant foreign investors the right to establish wholly-owned subsidiaries.

But careful investigation of the role of multinational corporations as a vertical channel for technology, management, and quality control imparted to host country suppliers suggests that Korea followed more closely the blueprint found in Hong Kong, Singapore, and Taiwan, than offering an alternative to their pattern of high tech industrial success.

Looking solely at industries where technology was stable and could be replicated with a combination of licenses and imported technical training – namely, steel and shipbuilding – a Korean “model” of protecting the domestic market, excluding foreign investment, and subsidizing exports readily fits the data.

But this characterization is inaccurate and misleading in important respects with regard to electronics.

In fact, foreign investors laid the base for an international competitive electronics industry in Korea from the mid-1960s to the mid-1970s, accounting for more than a third of production and 54 percent of electronics exports. The leading Korean electronics firms all reported that they entered export markets during the 1970s using technology and product design provided by those foreign firms that purchased their products and components for export.⁴⁶ They cited technology transmission via contract manufacturing and Original Equipment Manufacturer (OEM) relationships with foreign assemblers and retailers three times more than technology acquisition via licenses or joint venture partners.

In the 1980s Korean policy turned against foreign direct investment and many of the international electronics companies withdrew from production in Korea. But the OEM channel remained the central conduit between the Korean firms and foreign technology and foreign markets. By the end of the decade, according to Jun and Kim, 50 percent to 60 percent of color TVs and VCRs were still exported via OEM contracts, to purchasers such as Sony, Panasonic, Mitsubishi, Zenith, Toshiba, Philips, Zenith, RCA, and Hitachi.⁴⁷

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Looking at the three most successful Korean electronics companies — Samsung, Lucky Goldstar, and Huyndai — all began as suppliers to multinationals, and thirty years later still exported sixty percent of their electronics output via OEM relationships with the major international companies. Along the way, they expanded their own design capabilities, and — in some sectors — began to market their own brands in international markets.

The Korean experience parallels closely the development of the electronics sector in Taiwan as well. In Taiwan, firms in the electronics sector graduated from selling components for calculators, clocks, and VCRs, to contract manufacturing of power supplies, printed circuit boards, and monitors, for IBM, Philips, and Hitachi. The Taiwanese computer makers — such as ACER, Tatung, and Mitac — originated as OEM suppliers of subassemblies, before learning how to design PCs for sale in international markets under the buyer’s brand name.

Thus, as Michael Hobday has argued, the conventional view of Korea as following a different path from Taiwan, Singapore, and Hong Kong obscures the most important common thread in the experience of all four countries. That common thread is to use the guidance and discipline imposed by multinational corporations to move from contract manufacturing to Original Equipment Manufacturing, and thence — with a combination of imitation and incremental innovation — to Original Design Manufacturing (ODM) and — in the most successful cases — to Own Brand Manufacture (OBM) in competition with the international leaders in the industry.

This path has important implications for the development of national firms in high tech sectors in China, and other developing countries as well. It suggests that policies of trying to force technology transfer through mandatory joint venture and technology-sharing requirements — rather than through vertical supplier and OEM relationships with wholly-owned affiliates of the leading multinationals in each sector — is likely to run into the same resistance and difficulty as encountered elsewhere.

In the process of accession to the WTO, Chinese policy toward foreign direct investment has been in flux. In 2002, China dropped its official insistence that foreign investors meet mandatory domestic content targets in order to bring its foreign investment code in line with the Trade Related Investment Measures (TRIMs) Agreement negotiated during the Uruguay Round of Trade Negotiations.

The elimination of restrictions on foreign ownership, in contrast, has been less complete. In its “Guiding Directory on Industries Open to Foreign Investment”, China has established four categories: “prohibited sectors” (34 industries), “restricted sectors” (75 industries), “encouraged sectors” (262 industries), and “allowed sectors” (all other sectors).


Wholly-owned or majority-owned affiliates are allowed in the “encouraged” and “allowed” sectors. The seventy five industries in “restricted sector” category, however, have continuing limitations on the amount of foreign ownership.

But the record shows that ownership restrictions and other requirements for forced technology transfer have been met in China – as reported earlier in this volume for other countries -- with hesitancy on the part of foreign investors to expose their most advanced technologies and production procedures to operations over which they have limited control.

In a survey of 442 multinational firms operating in China in 2003, Guoqiang Long found that foreign wholly-owned and majority-owned firms were much more likely to deploy technology as advanced as used by the parent firm than firms that had 50-50 shared ownership or firms that had majority indigenous ownership.\(^{50}\) Thirty-two percent of the wholly-owned firms and 40 percent of the majority foreign-owned firms used technology as advanced as in the parent firm, whereas only 23 percent of the 50-50 shared ownership firms and 6 percent of the majority indigenous Chinese-owned firms used technology as advanced as in the parent firm.

Thus -- despite phenomenal success in attracting foreign direct investment -- China has experienced exactly the same difficulties as other countries when host authorities require foreign firms to operate with a local partner with a goal of forcing technology transfer.

In an imaginative variation on the authentic Samsung model, in contrast, Lenovo acquired IBM’s PC division with an on-going agreement to purchase system integration services from the IBM parent, essentially turning Lenovo into a contract manufacturer for PCs, while ensuring IBM’s self-interest in continuously helping to upgrade Lenovo’s PC products so as to integrate them into IBM’s larger “end-to-end IT solutions”.

7. The Globalization of Industry via FDI: New Costs and Burdens for Developing Countries

The assessment of how FDI impacts developing countries would not be complete if it were limited to examining the improvement in the efficiency of activities the host economy already engages in, the opportunity for the host to engage in completely new kinds of activities, and the thickening of the network of backward linkages and spillovers.

Even for countries that are successful in capturing these positive benefits, the experience of using the globalization of industry via FDI to drive indigenous development has an inherent downside – it exposes host country communities, firms, and workers to instability and dislocation associated with variations in international levels of economic output and changes in international patterns of production.

It would be difficult to overstate how inadequate are developing country policies and programs to help workers cope with the instability and dislocation that accompany the globalization of manufacturing and assembly.

But adjustment policies and programs in the developing world are not non-existent.

To gain perspective on what is realistically possible to expect in developing country adjustment policies, it is instructive to contrast two of the largest cases of FDI-related economic fluctuation – job creation and job loss – in recent times, the evolution of foreign-owned EPZ exporters in Pakistan, and the evolution of foreign-owned maquiladora and other manufacturing exporters in Mexico.
BOX INSERT

Contrasting Experiences with Instability and Adjustment: Pakistan and Mexico

Textile and Garment Exporters in Pakistan 2000-2005

While the Pakistani economy has benefited greatly -- in the aggregate -- from increasing integration into the international economy, the country presents a case notable for leaving workers and communities to cope with the strains and dislocations of globalization without support from public programs or institutions.

Throughout the 1990s, investment by foreign and indigenous firms in textiles and clothing constituted the most dynamic component of a generally stagnant manufacturing sector, accounting for 79 percent of merchandise exports in 2000, employing 40 percent of the industrial workforce, or approximately 1.6 million workers.

But, with the weakening of the world economy in 2001 and uncertainties arising from the expiration of the Multi-Fiber Arrangement, exports slumped. Virtually the only option the Pakistani government had for coping with the downturn was to let market forces work on their own. Fortunately, for the country, foreign and domestic investors responded positively, devoting some $6 billion to upgrading the textile export sector between 2000-2005.

Moving away from labor-intensive spinning operations, the new investment was concentrated in machinery for finishing “home textiles” (pillows, sheets, comforters) that are higher quality and higher valued-added than cotton yarn, gray cloth, and garments.51 Between 2000 and 2005, exports of bed-wear climbed 186 percent, towels 167 percent, and knitwear 160 percent. This represented a more capital intensive reconfiguration of the sector, creating four new semi-skilled jobs in finishing for every seven lost in spinning.52

The more-skilled winners and less-skilled losers among the Pakistani workforce were left to deal with their respective fates entirely on their own. Programs to cushion the dislocation for EPZ workers, or to retrain them for other occupations, were virtually non-existent.53 Pakistani capacity for vocational education and skill-building reflected a legacy of ruling elites preferring


52 Presentation of Dr. Ishrat Husain, Governor, State Bank of Pakistan, at Georgetown University, January 27, 2004.

to perpetuate low literacy rates and weak educational attainment among the lower classes.\textsuperscript{54} For men, Madrassahs that focus mainly on fundamentalist religious instruction filled the gap in primary education and training. For women, there was effectively nothing. Most of those laid off in the spinning sector had to rely on extended family relationships for support, with many returning to subsistence farming or employment in the informal sector.

Mexico, in contrast, shows a country with limited resources crafting policies to help alleviate the burdens associated with globalization.

Maquiladoras and Other FDI Manufacturing Exporters in Mexico 2000-2005

The history of maquiladora exporters in Mexico holds many lessons for contemporary developing countries.

Most of these lessons are of the \textit{“how not to do it”} variety.

The original maquiladora strategy was built upon special trade advantages: US tariffs were levied only on the value-added in Mexico, and not on the value of US inputs included in the finished product. US investors could ship parts across the border for assembly, and re-import the final good with only a minor duty.

Maquiladora plants grew up therefore in the extreme North, where population density was light and infrastructure and sanitary services poor. New workers traveled from the interior of Mexico to find employment in the plants. While wages were better than alternatives in the rural economy, reports of labor abuse were abundant, living conditions were frequently squalid, and environmental degradation was severe.

The structure of the tariff advantage offered minimum incentives for the foreign investors to form backward linkages into the Mexican economy, and the remoteness from sound educational resources initially ensured that maquiladora activities remained concentrated in lowest skilled operations.

The maquiladora system was thus a far cry from a development strategy of attracting foreign corporations to well-laid out industrial parks, with adequate infrastructure and social services, in close proximity to solid vocational training institutions and energetic host country supplier firms.

Many of the most successful FDI operations in Mexico – in particular, automotive engine and auto/truck assembly, and computer production -- where the incorporation of local suppliers and the establishment of backward linkages into the Mexican economy were greatest, grew up quite apart from the maquiladora system.

With the passage of NAFTA in 1994, the maquiladoras in most sectors lost their special trade advantages. But they continued to grow faster than any other sector in the economy, concentrated in apparel, electronics, and auto parts, demonstrating that Mexico’s comparative advantage in assembly operations did not depend upon artificial tariff advantages. Employment peaked in early 2001, at 1.4 million workers, accounting for nearly half of the country’s exports, valued at $83 billion. Firm level studies showed that the tripling of manufacturing exports over the course of the 1990s was associated with rising rates of adoption of modern production technologies, an acceleration of productivity growth, and a continuing increase in the demand for relatively skilled workers.

But – as in Pakistan -- with job creation came exposure to fluctuations in the world markets. Accompanying the US economic downturn in 2001, a strong peso, and rising competition from Asia, Mexico lost some 290,000 jobs as 900 plants shut down or moved away, one-third to China. Mexico was losing its comparative advantage in lowest-wage commodity products: the plastic statuette of the famous dark-skinned Virgin of Guadalupe was discovered bearing the label “Hecho en China”.

Like Pakistan, the primary policy response was to rely on new investors to fill the gap as old investors downsized or departed.

But unlike Pakistan, Mexican officials on both the federal and state level drew on well-established institutions and past experience to redouble efforts to target new kinds of investors, and match them with a more skilled local labor force. Baja economic development officer David Reyes described the new strategy: “We aren’t competing with cheap labor. That’s not our strong point.” He argued, “We are offering skills that other places don’t have.” The Mexican investment promotion authorities singled out companies engaged in more sophisticated activities than in the past, companies demanding higher quality control standards, and companies whose operations required same-time-zone coordination/cooperation in production.

Between 2001 and 2004, IBM reconfigured its Guadalajara facility to make high-end servers and storage products. Flextronics built a new technology center to perform x-ray laminography, and provide in-circuit testing services previously found only at headquarters. Plantronics built a plant that relied on superior quality control (1,129 defective units per million in Mexico versus 11,680 defective units per million in China) to more than made up for the difference in wages ($2.20 per hour in Mexico compared to $0.60 per hour in China). Jabil Circuit expanded its build-to-order and configure-to-order businesses, training the workers at its Mexican plant for

55Diane Lindquist, “Guadalajara is Mexico’s ‘Silicon Valley’, but booming city needs more assets to remain an electronics haven”, The San Diego Union Tribune, October 23, 2000.

those more complex production processes, while shifting long-production-run commodity products to Asia.

The search for new investors to set up Mexican manufacturing facilities turned up Pratt & Whitney to produce engine housing components and other precision aircraft parts, and Toyota to assemble truck beds for Tacoma pickups.\(^{57}\) Both reported being drawn by the high productivity of semi-skilled Mexican labor.

The success of this strategy of upgrading the operations of foreign-owned export plants depended upon education and training initiatives that Mexico had put in place – unlike Pakistan – over the preceding decade. During the 1990s, Mexico had steadily expanded the number of technical universities, offering a two-year professional degree – programs often allied with nearby foreign and domestic companies in designing curricula and providing apprenticeship-like positions for students.\(^{58}\) By 2003-4 Mexico placed near the mean of OECD countries in number of students enrolled in science and engineering programs compared to total tertiary enrollment, despite its relatively low per capita income.

Complementing the vocational training programs, Mexico also took steps to help workers cope with job dislocation – another contrast with Pakistan. During the 2001-2003 period, Mexico was able to draw on one of the most innovative and successful programs in the developing world to provide publicly funded training for displaced workers (called the “Probecat” program). Probecat provided publicly funded re-training for displaced workers, together with a subsistence allowance, for a maximum duration of six months. Carefully evaluated over the course of the 1990s to ensure that the program sped reemployment in comparison to a control group of non-participants, Probecat had grown by a factor of ten when the recession hit in 2001.

Beginning in 2003 exports from foreign-owned factories began to turn around, and – despite the end of the Multifiber Arrangement and the shift toward more capital-intensive activities – employment approached previous records over the next two years (1.2 million workers by 2005). Garment, shoe, and toy sectors shrank, while production of electric and electronic goods (similar to those of the companies identified above) more than took up the slack.

The success of Mexico’s efforts to upgrade the manufacturing export base revealed new problems, however, that would have to be overcome to take advantage of further stages in the globalization of industry. Transportation bottlenecks were beginning to negate the advantages of geographical proximity to the United States. Telecommunication service was trailing the new generation of links between the US and Asia in price and quality. To remain a competitive player within sophisticated North American sourcing networks would require major

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improvements in infrastructure, as well as a continuation of programs to upgrade the skills of the workforce.

To complete these two stories, the fate of the workers and communities in the *home country* from which the new investment in Pakistan and Mexico originated – the United States -- is the subject of a special box (OUTWARD INVESTMENT: Two Stories with Happy Endings, One Without) in Section IV of this volume.

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The experiences of Pakistan and Mexico (above) are useful for introducing a broader survey of what kinds of policies developing countries can realistically hope to pursue to cope with the dislocations associated with globalization, and what kinds of policies they should avoid.

For developing countries – just as for developed countries (see Section V) – the search for workable adjustment policies has not led to any “silver bullet” solutions that are satisfactory and effective, let alone quick-acting or low cost.

But there are three clusters of policy responses that can help. All three are likely to be more effective if they form part of the host country’s on-going social policy agenda, and are not suddenly invented in response to economic crisis when public resources are most strained.

The first cluster of policy responses centers on attracting new investors or helping existing investors reconfigure their operations to respond to competition from international markets. Here Mexico, unlike Pakistan, was able to deploy experienced investment promotion agencies already in place at the state and federal level to search out investors in novel activities like aircraft parts repair, and to obtain those permits needed for established investors to take on more sophisticated activities. Going one step farther, Ricardo Hausmann and Dani Rodrik suggest that host authorities might offer to co-fund feasibility studies to overcome imperfections in information markets for new kinds of investors and/or new kinds of operations.59 Host governments might also authorize finder’s fees for private zone developers that are successful in attracting non-traditional investors, and provide worker training grants to the new firms that arrive.

The second policy array involves the continuous expansion and upgrading of skills to endow workers and managers with the human capital they need to take advantage of changing circumstances, favorable and unfavorable.

Since the most effective labor training takes place on-the-job, a prime candidate is a training tax credit, in the form of a percentage of the payroll refunded to compensate firms for expenses associated with improving the skills of workers. The rationale for a use-it-or-lose-it tax credit derives from the inability of firms to preclude workers with acquired general production or linguistic skills from leaving, or to prevent rival firms that do no training from cherry-picking qualified workers at firms that do upgrade employee skills, leading all companies to spend less on training than what would be privately – let alone socially – optimal.

Along these lines, Brazil’s National Industrial Training Service (SENAI) compensates firms that provide on-the-job training from the proceeds of a compulsory 1% levy on payroll, a program that has proven successful in expanding worker instruction among medium and larger firms.60 Singapore and El Salvador likewise reimburse firm training expenditures from a 1% “skills


development” payroll tax. Kenya provides vouchers that allow trainees to choose among courses and providers.

Complementing the training tax credit is the creation of regional vocational training institutes and community colleges – like those in the Mexican example, above -- in which employers play a central role in design of the classes and renovation of the curriculum, in response to changes in the marketplace. Simply spending more money on education, especially university education – in contrast – has not proven to be as effective in providing the skills needed to enhance growth. 61

For quality assurance in vocational training, more than 20 developing countries have created accreditation agencies or other national evaluation systems to monitor inputs (trainer capabilities) and outputs (student capabilities). 62 As these boost demand for graduates on the part of firms, they have resulted in increased demand for instruction on the part of students.

The third policy array addresses the specific adjustment problems facing workers who have been laid off, while supporting their mobility in finding new jobs. 63 Here it is important to separate developing country programs that have shown themselves to be effective, from programs that are not – or, worse -- that have proven counterproductive.

Developing country success stories in upgrading the skills of workers who have been laid off are relatively rare, but the Probecat program, highlighted in the Mexican experience above, is one of the better examples, according to a team led by David De Ferranti. 64 Along with publicly funded re-training, Probecat provides workers with a living allowance, equivalent to the minimum wage plus transportation costs and health insurance, for up to half a year. Beneficiaries qualify based on a point scoring system, and are eligible for training only once. Training is carried out in firms, as well as schools and training centers.

A key issue for other developing countries that might want to emulate the Probecat approach is whether to design the program so as to be compatible or incompatible with holding a part-time job.

Job dislocation can be cushioned, and retraining provided on a private basis, through worker self-insurance, via individual savings accounts. Here a specified part of a worker’s salary is placed in an account that the worker “owns”. The account is generally held in a government-vetted financial institution, and in some cases – as with Brazil’s Fundo Garantia por Temp de Servicio –

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receives a guaranteed rate of interest. In the event of job loss, workers can draw resources from their accounts. Amounts that remain in these accounts at retirement can be turned into old-age pensions.

Income support for displaced workers can also be provided by unemployment insurance. As in developed countries, unemployment insurance in developing countries – Argentina, Brazil, Ecuador, Uruguay, and Venezuela, for example – is usually financed by joint contributions from employers and employees to a common pool. After a specified contribution period, workers are entitled to an unemployment payment in the event of losing their job (but not when there is voluntary separation). The payment is a specified percentage of the workers’ salary, usually declining over time. Payments continue as long as the worker remains unemployed, up to a maximum of months or years.

In developing countries where there is a large informal sector, however, there are drawbacks to using unemployment insurance systems. On the income side, many employers and employees do not contribute to the general insurance fund. On the expenditure side, it is often almost impossible to determine, in practice, whether workers who lose their jobs in the formal sector are in fact unemployed (as opposed to working informally while drawing benefits) or how long they remain totally unemployed.

A generic difficulty with unemployment insurance -- especially if it is administered on a local or regional, as opposed to a national, basis -- is that it may encourage workers to stay put, waiting for their old jobs to come back, rather than moving about or accepting a new job at lesser pay. A thirty day waiting period to receive initial payment of claims, with what De Ferranti et al. refer to as “frugal benefits”, can reduce the incentive to remain unemployed. So can tying the benefits to evidence of active job search, and decreasing over time the fraction of the salary that is replaced.

To avoid the hazards of unemployment insurance, Chile has created a jointly-funded portable system of individual worker accounts that can be drawn upon during periods of unemployment, or accumulated to pay for retirement. Displaced workers have an incentive to use the accounts sparingly, to leave as much as possible for old age.

To encourage worker mobility, wage insurance can be used to stimulate displaced workers to accept a new job even if the pay is lower than the previous occupation. With wage insurance, the worker receives a fraction of the difference between pay in the old job and pay in the new job for a certain period of time, beginning from the acceptance of the new position, hence speeding

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65 A weakness in this approach is that it does not pool unemployment risk. De Ferranti et al, op. cit., p. 99. In some countries, workers can also borrow from their accounts to meet other specific needs besides layoffs, such as medical emergencies.


adjustment. As Section V points out, such programs are acquiring fresh appeal in developed countries. But since the salary supplement comes from public sources, the fiscal burden can be costly and come at a time when the government budget is under most pressure.

Absent from the list of recommended adjustment programs is one of the most widespread approaches to compensating workers who lose their jobs – namely, mandatory severance pay provisions. Mandatory severance pay raises the fixed cost of hiring workers, and is likely therefore to discourage hiring in the first place. In Sri Lanka dismissed workers receive 2-3 months’ salary for each year of employment, for example, leading to severance payments sometimes in excess of 25-30 months’ wages.\footnote{WORLD DEVELOPMENT REPORT 2005, p. 147.}

The rigidities that result from mandatory severance pay hurt both firms and workers: employers have difficulty adjusting the size of their workforce in response to economic fluctuations; employees are deterred from seeking better jobs when such are available. Finally, there are burdensome administrative costs with mandatory severance pay programs. Martin Rama and William Maloney have found that most of the grievances handled by labor courts in Latin America, for example, are related to relatively minor disputes about severance pay, rather than to the more severe “sweatshop” issues raised in the next Section.\footnote{Martin Rama and Willian Maloney, “Income Support programs for the Unemployed in Latin America”, cited in De Ferranti, et al., p. 102.} Over the course of the 1990s, before Brazilian severance pay adjudication was reformed, an average of 2 million salaried workers filed a lawsuit each year (6 percent of the total workforce), with settlement of the typical dispute taking three years.\footnote{WORLD DEVELOPMENT REPORT 2005, pp. 147.}

To address these shortcomings, some countries have introduced pre-funded severance-pay savings accounts.\footnote{Milan Vodopivec. 2004. \textit{Income Support for the Unemployed: Issues and Options}. Washington, DC: The World Bank.} In Colombia, employers are required to deposit a portion of wages into guaranteed individual accounts upon which workers can draw if they become unemployed. Employers can be expected to shift most of the cost of severance payments onto the workers, but – in the Columbian case – total compensation to workers has risen. In 2002, Chile introduced a variation on this system. In both countries, worker access to their accounts is automatic, should they be laid off.

Thus, in concluding this Section, the assessment of the impact of the globalization of trade and investment on developing countries requires a penetrating look at the exposure of workers and communities to new uncertainty and instability. While developing country workers consistently report that the jobs they obtain in foreign-owned plants – or in plants supplying foreigners – are higher than the alternatives available to them elsewhere in the host economy (see the Box “Wages for MNC Workers and Subcontractors” in the next Section), there can be no doubt about the severity of the burdens on those who may suddenly find themselves without the more favorable job they previously enjoyed. The most labor-friendly response must take the form of
public and self-funded programs to equip workers to cope with change, however, not to trap them forever in unproductive and uncompetitive activities.
Section II
Enhancing the Ability of Poorer Countries to Attract and Harness Foreign Direct Investment for Development

Can low-income states use foreign direct investment to enhance their domestic growth, welfare, and reduction of poverty, in ways middle-income developing states have achieved?

What are the lessons from low-income states that have been relatively successful?

Do states that want to attract foreign investors in low-wage, labor-intensive sectors like garments, footwear, and toys have to lower their labor standards to do so?

This Section begins with the analysis of how two initially low-income states – Mauritius and the Dominican Republic -- managed to become successful in attracting FDI in manufacturing and assembly. It examines the checkered record of using Export Processing Zones or Duty Free Zones to attract labor-intensive foreign investment, suggests how investment promotion efforts might be improved, and derives lessons for how contemporary poor states might get started, as Madagascar and Lesotho have done.

Next this Section turns to the question of whether low-income states must tolerate poor worker treatment to secure foreign investment in low-skilled industries, like garments and footwear. It surveys the evidence on wage levels paid by multinational investors, and examines whether there are wage spillovers to local firms. It assesses the debate about whether minimum wages or “living wages” would serve worker interests, and examines the feasibility and desirability of trying to enforce labor standards as part of trade agreements.

This section concludes by sketching the path low income states have taken – and can continue to take – to move up the ladder from least-skilled foreign investment activities, to more-skilled foreign investment activities, while improving worker treatment, strengthening domestic firms, and increasing backward linkages and spillovers into the local economy.
1. Poor Country Success Stories: What are the Lessons?

In the midst of repeated failures by many low income states to use foreign direct investment for development, there is nonetheless good news. The challenges of attracting and benefiting from FDI – while often difficult – have proven quite surmountable for a diverse array of low income countries. These poor country success stories offer straightforward lessons for others to emulate.

To be sure, the flow of foreign direct investment to the developing world has always been quite concentrated. In 2004, twenty countries – none of them least-developed countries lacking favorable natural resource endowments – received 76% of total flows of foreign direct investment to the developing world and economies-in-transition (see Table 1). Over the past four decades, twenty countries – none of them least-developed countries lacking favorable natural resource endowments – have accumulated 66% of the total stock of foreign direct investment in the developing world and economies-in-transition (see Table 2).

And the list of ingredients of a good business climate, as enumerated by multinational investors – see Section I – is long and daunting.

As a consequence, there has been a tendency to conclude that the difficulties for poorer countries to join the ranks of countries able to attract and utilize non-extractive foreign direct investment must be overwhelming, and – in the case of tropical countries, remote countries, sub-Saharan African countries -- almost impossible to overcome.

But the evidence indicates otherwise.

Two of the more prominent success stories in the literature on foreign direct investment and development are Mauritius, and the Dominican Republic. Their accomplishments required straightforward policy reforms that are readily duplicate-able.\(^{73}\)

How did Mauritius and the Dominican Republic achieve their success with foreign investors? What do other low income states have to do to replicate their accomplishments?

*The Case of Mauritius.*

Part I of this volume pointed to Mauritius as the country that inspired Paul Romer’s model of dynamic transformation of comparative advantage via foreign direct investment. The selection of Mauritius could well seem puzzling, given the country’s impoverished starting-point not so long ago.

Mauritius in the 1960’s was dependent on sugar production for 99 percent of its exports. Unemployment was high. Jobs in local industry were limited to sectors protected by import-

substitution policies. A study commissioned by the British prior to independence was entitled “Mauritius: A Case Study in Malthusian Economics” – its dismal message was that young workers who were able to secure some education should be urged to emigrate.\textsuperscript{74} Mauritius found itself in the tropics, as part of Africa, occupying one of the most geographically remote sites in the developing world.

In 1975 the government introduced legislation to confer Export Processing Zone status on foreign investors who committed themselves to exporting their output. Export Processing Zone status allowed 100 percent foreign ownership, and a ten-year tax holiday. But the country continued import substitution policies, subsidized inefficient state owned utilities, ran unsustainable budget deficits, and maintained an overvalued exchange rate complete with currency controls and foreign exchange rationing. Flows of foreign investment remained weak.

In 1982 a new political alliance ousted the party that had been dominant since electoral politics had been introduced in 1947. It liberalized the currency, retreated from subsidizing state corporations, and adopted an aggressive policy of voluntary structural adjustment. To help make up for weak infrastructure, foreign investors were granted Export Processing Zone status wherever they chose to locate in the island-country, often choosing sites where transport and utility services were best. Duty-free access to imported inputs, preferential tax treatment, and free repatriation of capital and profits effectively segmented the EPZ sector from other parts of the economy that remained protected.\textsuperscript{75}

Led by textile investors from Hong Kong, foreign investment began to expand. Export earnings from manufactures in Mauritius climbed from 3 percent of the total in early 1970s, to 53 percent in 1986, surpassing traditional sugar exports for the first time. By the mid-1990s, Steven Radelet shows that Mauritius ranked seventh among the fifteen most consistently growing exporters of manufactured products among low and middle income countries around the world – less spectacular than Singapore, Taiwan, and Hong Kong, but superior to such high performers as Thailand, Portugal, and Israel, with an average annual growth rate of 2.9 percent per year.\textsuperscript{76} By 2005, manufactured goods constituted 70 percent of all exports, totaling more than $1.2 billion annually, and sustaining more than 68,000 jobs.

Like most low income developing countries, Mauritius was initially disappointed by the lack of spillovers and externalities from zone investors, and frustrated that the great majority of foreign firms were concentrated in lowest-skilled labor-intensive operations. In 1985, the government

\textsuperscript{74} The author of the study was James Meade, later winner of the Nobel Prize in Economics, Port Louis, Mauritius, 1960.


redirected the Mauritius Export Development and Investment Authority from screening inward investment so as to maximize the contribution to import substitution, to searching out novel export-oriented companies. French, UK, German, Taiwanese, and Chinese investors began to join the ranks of those from Hong Kong. Taking advantage of a trainable but not terribly highly skilled workforce (4.5 years average schooling), foreign firms with EPZ status began to appear in sectors such as sports equipment and other light industry, agribusiness, tuna canning, and cut flowers, as well as higher-end garments such as shirting for Marks and Spencer.

At the same time, the government of Mauritius began to attend to the wellbeing of its indigenous business community, reducing regulatory requirements to establish a local business, and lowering the corporate tax rate for non-zone manufacturers from 35 percent to 15 percent. This helped local entrepreneurs to become suppliers to foreign-owned exporters, and gave them a platform to enter export markets themselves. Indigenous managers and supervisors with experience in foreign-owned plants began to use their acquired expertise to set up their own companies.\(^77\) By the late 1990s indigenous investors held 50 percent of all equity capital in zone-status firms.

With wage rates 3-4 times higher than those in China and needing to reinforce the productivity of its workforce, Mauritius increased the number of pre-vocational and technical schools in 2000, and made secondary education mandatory to age 16. It opened a fiber optical cable at the end of 2002, and established the Ebene CyberCity, a business park with world-class telecommunication facilities in 2004. With a multilingual population, fluent in French and English, the country enjoys a comparative advantage in call centers serving European, North American, and Asian markets for business support, customer care, and data management. At the high end, Mauritius-based firms offer investment advisory services, fund management, trusteeship of offshore banking accounts, and private banking. The government pays up to 70 percent of the training cost for workers in IT areas such as software development.

As of 2005, firms in Mauritius – both foreign-owned firms and locally-owned firms – engage in more subcontracting with indigenous firms (21%) than is common in other African countries, almost twice as much as Madagascar (11%), and more than three times as much as Senegal (6%) or Tanzania (6%).\(^78\) This may be traced to the fact that domestic business operating conditions are superior across a number of variables, especially favorable tax rates and tax administration, superior access to finance, lower economic and regulatory policy uncertainty, better customs and trade regulations, and more reliable electricity and telecommunications.\(^79\) For EPZ investors,


\(^78\) Manju Kedia Shah, *Subcontracting in Sub-Sahara Africa*, working paper, the World Bank, February, 2006, Figure 1, p.2.

this may also be due to the on-going policy of having EPZ as a status rather than a geographical location, so that an export-oriented investor can locate wherever in the country best suits the firm’s needs rather than in a designated zones.

At the same time, however, firms in Mauritius report that labor regulations and problems with business licensing and obtaining operating permits constrain their activities. In addition, leaving monopoly control over the fiber optic cable system in the hands of Mauritius Telecom, however, generates costs five times as high between Mauritius and Paris than between Reunion and Paris, thus limiting the country’s evolving comparative advantage in areas that rely on IT exchange.

The Case of the Dominican Republic

The Dominican Republic might likewise seem like an improbable place to look for FDI-led economic success, given the country’s predominant agricultural base and poverty level (per capita GDP only two-thirds as high as Mauritius) when it started try to lure FDI in manufacturing and assembly. The efforts of the Dominican Republic to attract foreign direct investment to Export Processing Zones date from the late 1960s, but budget deficits, high inflation rates, and an overvalued exchange rate prevented the country from becoming an export base for foreign investors throughout the 1970s.

Macroeconomic reform in the early 1980s, however, combined with a shift in EPZ strategy, to begin to generate results. Like many host governments (including Costa Rica, in Section I), Dominican authorities had initially considered Export Processing Zones as a form of employment creation for the most destitute regions of the country, near the border with Haiti. But the combination of poor infrastructure and least-skilled workforce limited the appeal of such locations to foreign investors. As the government opened up more sites for EPZ activity, closer to Santo Domingo, the number of investors expanded, reaching 178 firms in 1987, employing some 85,000 workers.

In an effort to upgrade and diversity the country’s FDI-led export base, Dominican authorities adopted what Section I reported to be a novel approach at the time: they began to allow private developers to launch new EPZs, and to permit international companies in more sophisticated industries to operate both as investors and as promoters. In the model Itabo zone, Westinghouse acted as zone owner/manager as well as exporter, soliciting other Fortune 500 companies to set up operations along side its plants. In the San Isidro zone, GTE (now Verizon) pulled other electronics firms to the Dominican Republic. One group of Dominican zone developers designed the Las Americas zone for information services. Other private zone operators configured pharmaceutical industrial parks to meet the inspection standards required by the US Food and Drug Administration. Electronics, electrical equipment, pharmaceutical products, metal products, agro industry, data processing and other services became the largest new sectors represented, totaling 38 percent of all zone investment by 2004.
The Dominican Republic case offers unusually detailed data on where the workers in these increasingly sophisticated FDI operations acquired their skills.\textsuperscript{80} Eighty five percent of those employed in US firms, and 80 percent of those in Korean, Taiwanese, and Hong Kong firms reported that they had developed their skills exclusively through on-the-job training within their current firms. In the first group, this led to productivity increases of 44 percent in the second year after the start-up of operations and 10 percent in the third. In the second group, the productivity increase was 67 percent in the second year, and 13 percent in the third. These large productivity increases derived from rather modest company efforts: 2-to-3 months of on-the-job training for unskilled workers, with learning-by-doing continuing through the first year.

As in Mauritius, the number of indigenous start-ups within the Export Processing Zones grew, many of them populated with workers and managers initially trained in foreign plants. In 1990, twenty percent of all zone companies were owned and managed by Dominican citizens; by 2003, this number had grown to thirty four percent (180 of 531 zone companies).\textsuperscript{81} Despite global uncertainties – including the end of the Multifiber Arrangement – forty new zone businesses opened in 2004, creating approximately 10,000 jobs. As of the start of 2005, total zone investment exceeded $1 billion, total zone employment was 197,000, total zone exports reached $4.4 billion (81 percent of the country’s total exports, and virtually the entirety of its manufactured exports).

Can other low income countries follow the example of Mauritius and the Dominican Republic in incorporating foreign direct investment into a coherent development strategy?

Many poorer developing countries have found that the effort to attract even the lowest-skilled foreign direct investment often fails.

How can low income countries get started, and what should they do to maximize their chances of getting launched with success?

\textsuperscript{80} Yung Whee Rhee, Katharina Katterback, and Jeanette White, \textit{Free Trade Zones in Export Strategies, op. cit.}, p. 18-24.

2. Using Export Processing Zones (EPZs) to Get Started With Low-Skilled Labor-Intensive Foreign Investment

As in the case of Mauritius and the Dominican Republic, the typical effort to attract foreign direct investment in lowest-skilled operations starts with trying to create some sort of Export Processing Zones or Free Trade Zones. But Export Processing Zones and Free Trade Zones have a very problematic record.\textsuperscript{82}

What separates EPZ successes from failures?

The rationale for Export Processing Zones and Free Trade Zones is to offer foreign investors freedom from duties on the capital equipment and inputs used in assembly operations, to enable them to operate with reliable competitively-priced infrastructure, and to shield them from adverse business conditions that may afflict other parts of the economy (corruption, crime, bureaucratic delay, high taxes, legal uncertainty).

The principal reason why EPZs and FTZs have failed in low income countries is that host authorities have simply not delivered these conditions. Ports and airports experience delays. Telecommunications services are undependable and expensive. Electric power outages necessitate back-up generators. Bonded warehouses (single factory EPZs with a customs agent at the site) and duty-drawback arrangements (where duties on imported inputs are reimbursed when the final product is exported) require bribes to function smoothly. Crime plagues workers and managers living near the zones.

Beyond providing at least the beginnings of a business-friendly setting, foreign investors need low inflation and a realistic exchange rate. The boom in exports from Mauritius and the Dominican Republic did not take place until exchange rates accurately reflected market conditions. An increasingly overvalued exchange rate in Kenya caused some 60 of the 70 bonded warehouses in the country to cease operations over the course of the 1990s. An artificially high exchange rate long hindered export-oriented investment in Egypt despite extremely generous tax incentives.

Another impediment to launching successful EPZs has been the proclivity to use the zones for direct poverty reduction. But, as the Dominican Republic learned from the zones near the Haitian border, the decision to locate EPZs in the poorest and most remote regions has seldom resulted in attracting large numbers of foreign investors or generating rapidly growing amounts of exports. For two decades, the most widely analyzed Export Processing Zone in all development literature was the zone that the Philippine government established in Bataan in an attempt to attract investors to where the wages were cheapest and the workers most needy. But the mountainous area around Bataan was bereft of good infrastructure, and the Philippine

government had to spend millions of dollars to compensate. The Bataan zone generated a sufficiently unfavorable cost-benefit ratio that it attracted ridicule in the analytic community.\textsuperscript{83} Much more successful have been policies permitting foreign investors to qualify for “zone status” wherever the investors choose to locate (as Mauritius did from the beginning), or setting up the zones in proximity to host country economic centers (as the Dominican Republic and the Philippines finally did), to allow the investors to take advantage of superior infrastructure and more skilled workers.

Mauritius and the Dominican Republic are by no means unique among relatively poor developing countries in creating hundreds of thousands of jobs and generating hundreds of millions of dollars of exports from foreign investor operations. The evidence shows that would-be hosts do not have to achieve anything like perfection to be successful in getting started on the road to using non-extractive foreign investment for development. A little macro, micro, and institutional reform – backed by a consistent trend-line – goes a long way. Notwithstanding the extensive MNC “wish list” for what constitutes a good investment climate – as spelled out in Section I -- a poor developing country does not have to “become like Denmark” to attract and benefit from foreign direct investment.

\textit{The Case of Madagascar}

Explicitly trying to emulate Mauritius, Madagascar, for example, made the decision to liberalize its economy, end an overvalued exchange rate, and establish an Export Processing Zone-led growth strategy in 1989.\textsuperscript{84} Like Mauritius, Madagascar awarded EPZ status to investors regardless of where they choose to locate in the host country. The pace of success in attracting foreign investors was even faster than had been the case in Mauritius, with 120 firms setting up operations in the first five years in Madagascar in comparison to 100 firms in the first ten years for Mauritius.

Between 1994 and end-2004, exports from Madagascar’s EPZs grew from $64 million (14 percent of all exports) to $497 million (54 percent of all exports), with 180 companies. Zone employment climbed by 22,000 during the course of 2004, to 107,000 workers, then dropped by 8,000 in 2005 with the end of the Multifiber Arrangement. Ten percent of the EPZ firms are owned and managed by Malagasy businessmen.

The lack of vocational training to provide skills for mid-level managers and technicians has required foreign firms to bring in expat supervisors and quality control experts, and limited the creation of backward linkages and spillovers into the local economy. In contrast to Mauritius, moreover, poor business operating conditions outside of the EPZ zones have led to a clear dualism in firm performance in the domestic economy.\textsuperscript{85} Non-EPZ firms have much lower

productivity than counterparts in all other Sub-Saharan countries except Zambia. The percentage of firms subcontracting with other Malagasy firms is about half (11%) what is found in Mauritius. 86 The constraints on firm performance include lack of access (and high cost) of finance, high tax rates and problematic tax administration, high economic and regulatory policy uncertainty, unreliable electricity, and unfavorable customs and trade regulation. Unlike Mauritius, most EPZ investors are concentrated in particular geographic locales rather than spread throughout the economy.

The Case of Lesotho

Elsewhere in Africa, Lesotho attracted 55 foreign export-oriented manufacturing firms between 1995 and 2002, 38 producing clothing, three producing footwear, four producing electronics, four involved in food-processing, and the rest producing assorted products such as umbrellas and plastic goods, for a total of $273 million in exports. In the last quarter of 2004, however, six companies closed down, reducing employment by 7,000 to 43,000 workers.

To cushion the impact of increased competition in garments, Lesotho has sought to diversify into high-value agricultural exports. A canning factory investor began exports of asparagus and peaches in 2004. Over the longer term -- if not blocked by the South African trade unions -- Lesotho might be able to integrate its foreign export-manufacturing sector into the South African economy the way Mexico has done via NAFTA. Although land-locked, Lesotho has access to South Africa’s relatively efficient transport network.

As before, these country experiences do not suggest that the task of attracting low-skilled labor-intensive foreign direct is easy; but their country experiences do show that the task is highly doable.


3. Investment Promotion for Poorer States

The payoff to effective investment promotion along the lines spelled out in Section I is no less valuable to poorer developing countries as it is to richer developing countries. But many low income developing countries have remained significantly behind the frontier of “best practices”.

Some obstacles are generic for all firms – foreign and domestic -- contemplating a prospective investment, such as verifying rights to land and other property, enforcing contracts, dealing with bribery, and avoiding expropriation without compensation. Other obstacles are particularly prominent for international investors, such as foreign company registrations, expatriate work and residence permits, and other special licenses and approvals.

In a survey of the foreign investment “promotion” process in Africa, for example, the Foreign Investment Advisory Service of the World Bank Group discovered time-consuming screening by multiple agencies with overlapping jurisdictions and conflicting mandates, rather than the one-stop-shop investment promotion agencies designed to facilitate entry, described in Part I.. The result was that it took one to two years for foreign investors to establish a business and become operational in Ghana and Uganda, and eighteen months to three years in Tanzania and Mozambique. This contrasts with 6 months or less in the Dominican Republic, Malaysia or Thailand.

Twenty-five African investment promotion agencies have signed up as members of the World Association of Investment Promotion Agencies (WAIPA), but their websites do not show up-to-date economic or legal information, with links to key ministries and satisfied investors. Export Processing Zones and industrial parks are supervised by under-staffed government regulators rather than being licensed to private sector developers.

Once again, however, the challenges are not insurmountable. With a determined effort to renovate well-entrenched bureaucracies devoted to heavy-handed, case-by-case screening of applications, FDI-approval procedures have improved significantly in Mozambique, Ghana, Senegal, and Uganda between 2000 and 2004.\(^{87}\)

In the latter case – Uganda – a new code to protect investors against expropriation and the return of property confiscated under earlier regimes, together with macroeconomic stability and trade liberalization, have helped boost growth above 4 percent and reduce the percentage of the population living below the poverty line to less than 35 percent (compared with 56 percent a decade earlier).\(^{88}\)


Recognizing the high pay-off to effective investment promotion, the Inter-American Development Bank and the Asian Development Bank, like the International Finance Corporation of the World Bank Group, provide assistance for the creation of investment promotion agencies, and training for investment promotion personnel. The Multilateral Investment Guarantee Agency of the World Bank Group (MIGA) offers a web-based interactive system that – for countries that keep their country sites up to date -- has dramatically reduced the search time, effort, and expense for investors to evaluate countries, compare legislation, and link up with established investors, on a real-time basis.\(^8^9\)

“Investment promotion” has a cumulative dynamic: it takes a pro-active, efficient agency to attract the early investors and investment park developers; the presence of the early investors then creates an opportunity for private industrial park developers to use their home-country networks (in the US, Europe, Japan, Korea, Taiwan, India) to find new investors; the interaction of already-established investors and aggressive developers provides comfort and credibility to follow-on investors in established sectors and to pioneer investors in novel sectors.

For countries that do not have the wherewithal to launch an effective investment promotion agency – or even to update the information on their websites – this cumulative virtuous cycle never gets started. “Investment promotion” therefore qualifies as a prime candidate for external assistance and capacity-building on the part of developed countries. The Lesotho National Development Corporation (LNDC), a central player in the country’s successful FDI-led export drive, was launched, for example, with an equity stake from the German Finance Company for Investments in Developing Countries.

This proposal for assistance in investment promotion will reappear in Section V, on how developed countries can best facilitate foreign direct investment for development.

\(^8^9\)www.ipanet.net
4. Must Low Income States Tolerate Poor Worker Treatment To Attract Foreign Investment?

Low income country leaders have voiced fears to the International Labor Organization -- and elsewhere -- that the attempt to attract foreign direct investment in labor-intensive sectors exposes their economies to race-to-the-bottom pressures, impelling them to weaken regulations governing workers.  

What does the evidence about indicate about the need to lower labor standards to attract foreign investors (and their subcontractors)?

On the one hand, the labor costs for foreign investors or FDI subcontractors with lowest-skill operations -- such as making garments or footwear for export -- range from 20% to more than 200% of the profit margin at the production stage. Barriers to entry are low, and competition is vigorous. Owners and managers at this stage are likely to find themselves under strong pressure to keep wages and benefits low in current plants, and to be on the lookout for alternative locales where unit labor costs might be lower still. They frequently threaten to close the plant and move elsewhere if workers -- or host authorities -- propose actions that raise labor costs.

In addition, some international investors (and their home governments) have explicitly demanded weak labor standards as a condition of investment. According to the ILO, the governments of Namibia and Zimbabwe, for example, were being told in the mid-1990s that their EPZs would have to be excepted from national labor laws in order to be successful. Pakistan admitted to the ILO that its EPZs had been exempted from some aspects of national labor legislation as a result of pressure from Daewoo. The ambassadors from Japan and Korea intervened on behalf of home-country investors to pressure the government of Bangladesh to forbid trade unions in export zones. This was countered by US threats to withdraw GSP if unions were forbidden. Bangladesh compromised with a five-year plan to phase in union representation.

The historical record of workers being fired for organizing unions in Export Processing Zones -- or arrested, or murdered -- is notorious. The early years of the experience with EPZs in the

90 This section draws upon materials developed in more detail in Beyond Sweatshops, op. cit.


Dominican Republic and the Philippines, just to name two countries considered earlier, were wracked with labor strife.

On the other hand, however, the aggregate evidence does NOT show that poor labor standards act as a magnet to attract foreign direct investment.

Mita Aggarwal, of the U.S. International Trade Commission, examined the relationship between labor standards and U.S. investment in ten developing countries (China, Hong Kong, India, Indonesia, Malaysia, Mexico, the Philippines, Singapore, South Korea, and Thailand).\textsuperscript{94} Aggarwal could find no association between measures that pointed to weak enforcement of labor standards and the level of U.S. foreign direct investment in these countries. On the contrary, U.S. investors tended to favor countries with higher labor standards, and to invest in sectors within a given host country where labor conditions were equal to or better than labor conditions elsewhere in the economy.

In a study of thirty-six developed and developing countries, Dani Rodrik also discovered no statistical relationship between low labor standards and increasing levels of US foreign direct investment. The evidence pointed, in fact, in the opposite direction: nations that had low labor standards had lower amounts of foreign direct investment than might be expected in light of other host country attributes. These results, proposed Rodrik, "indicate that low labor standards may be a hindrance, rather than an attraction, for foreign investors."\textsuperscript{95}

Thus the contention that host government are obliged to endorse poor worker treatment in order to attract foreign investors in labor-intensive industries -- or must expect to find their workers receiving substandard wages, benefits, and working conditions when foreign investors arrive -- is not supported by the data (for more details, see the next Chapter in this Section on “Wages Paid to MNC Workers and Subcontractors”).

Nor is the perception that EPZ-led development is incompatible with the existence of trade unions accurate in today’s world. To be sure, most foreign investors in Zones and Zone developers have historically been adverse to union-organizing in EPZs. But in more recent times the evidence has been mixed. The Philippines had a bloody history of anti-union repression in its EPZs in the 1970s and early 1980s. By the 1990s, however, as the right to union-organizing became legally permitted and recognized in the zones, some of the EPZs with least-skilled workers witnessed successful unionizing (one third of the firms in the Bataan zone, for example, operate with union contracts); other EPZs with higher-skilled industrial products plants, such as


the Cavite and Baguio City zones, had elections in which workers chose not to form unions. Similarly, prior to 1992, the Dominican Republic exempted its zones from the national labor legislation. With help from the ILO, in 1992, the Dominican Republic began to apply its labor legislation uniformly throughout the economy. Like the Philippines, firms in the EPZs devoted to lower-skilled operations sometimes became unionized; firms in those EPZs beginning to attract higher-skilled plants tended not to.

In Mauritius union organizing was permitted at plants with zone-status, and approximately 10 percent of workers in zone-status firms became unionized. In Lesotho, approximately 40 percent of garment workers are registered with the Lesotho Clothing and Allied Workers Union (LECAWU), an organization supported by Dutch funding.

Moreover once host countries begin to move out of the very least sophisticated investor operations into slightly more sophisticated investor operations exporting products that must meet higher standards of quality and reliability in international markets – in electronics, medical devices, auto parts, and the like – foreign investors find that they must take measures (in their own self-interest) to attract and retain superior workers. In these sectors, as documented in detail later in this Section, foreign investors pay workers two-to-five times more than what is found in garment and footwear industries; working conditions are demonstrably superior, sometimes including daycare, healthcare, and educational opportunities associated with work.

What is surprising in the data – and heartening for improvement in labor standards -- is the discovery that not only do workers’ income and working conditions improve in the plants devoted to the slightly higher skill-intensive operations but better treatment spills over into older and less sophisticated plants. That is, when plants producing more skill-intensive products are mixed with plants producing less skill-intensive products, the treatment of workers shows progress among all plant-types. Countries that have begun to add slightly more-advanced investor activities to least-advanced investor activities have experienced a broad process of institutional change in worker-management relations across EPZs and industrial parks in the host country.

In the Philippines, as noted above, the Bataan Export Processing Zone long had a record for some of the most repressive labor practices ever reported to the International Labor Organization. As foreign investors in electronics, chemicals, plastics, optical equipment, metal fabrication, and heavy equipment began to move in beside the plants producing soccer balls, jewelry, textiles, and shoes, however, labor standards improved across the board, rates of unionization increased, health and safety procedures got better, and business-labor relations showed more harmony and less strife.

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97 This hypothesis is tested, and affirmed, in Beyond Sweatshops, op. cit..

98 Ibid.
In the Dominican Republic, as medical equipment, electrical equipment, metal products and data processing became the fastest-growing zone investors, the directors of the association of zone employers, the trade unions, and the government called upon the Catholic Church to mediate the extension of the national labor code into the zones. The ILO Global Report 2000 pointed to the Dominican Republic as a “positive example” of a host government improving labor relations – and recognizing freedom of association – in its EPZs.

Indeed, the evidence suggests that increases in the number of firms, and the upgrading of foreign investor operations, constitute one of the most powerful forces developing countries can utilize to generate widespread improvement in the treatment of workers.
5. Wages Paid to MNC Workers and Subcontractors

How much do foreign investors pay to workers in comparison to domestic firms, and what accounts for difference in wage rates? Are there wage “spillovers” from foreign investors to domestic employers? How do wage levels change as MNC activities become more sophisticated and require higher skilled labor?

Investigations by the International Labor Organization consistently find that wages paid by foreign firms and subcontractors in Export Processing Zones are higher than alternatives elsewhere for the workers. World Bank surveys report that foreign-owned firms tend to provide permanent contracts to a larger share of their workers, and to provide more training for their workers, than indigenous counterparts. 99

Edward Graham shows that compensation per indigenous worker in foreign affiliates in the manufacturing sector is greater -- as a multiple of average compensation per worker in the host country manufacturing sector -- for poorer countries, in fact, than for middle-income developing countries. In middle-income developing countries the ratio is 1.8, in low-income developing countries, the ratio is 2.0 – that is, twice as high as the average compensation in the manufacturing sector of the host country. 100

These higher wages paid by foreign firms might simply arise because multinationals are attracted to higher wage sectors or to higher wage regions of a given country, or because their plants are larger or newer than the average plant.

Studies that hold sector, region, and plant characteristics constant, however, continue to find a significant wage premium paid by foreign firms. 101

In Madagascar, after taking education level, employment experience, and length of tenure into account, Mireille Razafindrakoto and Francois Roubaud found that workers in foreign plants and the plants of their subcontractors earned 15-20 percent more than comparable workers elsewhere in the host economy. 102


100 Edward M. Graham, Fighting the Wrong Enemy: Antiglobal Activists and Multinational Enterprises (Washington, DC: The Institute for International Economics, 2000, Table 4-2, pp. 93-94. Graham eliminates salaries for foreign managers and supervisors from these calculations.


Drawing on data from almost 20,000 firms in Indonesia, Robert Lipsey and Fredrik Sjoholm found that foreigners paid 33 percent more for blue-collar workers and 70 percent more for white-collar workers than locally owned firms.\footnote{Robert E. Lipsey and Fredrik Sjoholm. 2004. FDI and Wage Spillovers in Indonesian Manufacturing. \textit{Review of World Economics} 140. no. 2: 287-310.} When controls were introduced for region and sector, the premium remained at 25 percent for blue-collar workers and 50 percent for white-collar workers. When additional controls were introduced for plant size, energy inputs per worker, other inputs per worker, and the proportion of employees that were female, the foreign firm premium remained at 12 percent for blue-collar and 22 percent for white-collar workers. Overall, approximately one-third of the foreign-ownership premium was accounted for by region and sector, one-third by plant size and use of other inputs, with one-third left unexplained. Lipsey and Sjoholm concluded that MNCs were raising wages for both blue-collar and white-collar workers above and beyond what might be due to increased productivity coming from more inputs per worker or increased efficiency due to greater scale of production.

One reason why foreign investors pay premium wages could be that they are responding to Corporate Social Responsibility pressures from the home country, but much of the data showing higher wages predate the rise in CSR activity during the 1990s. Another explanation might be that foreign firms are more likely to obey laws regulating minimum wages, benefits, overtime pay, and anti-churning regulations, but the premium is not concentrated in the ranks of the lowest-paid workers – instead, it grows as skill-level increases. Perhaps – since foreign firms provide more on-the-job training -- the willingness of the foreign firms to pay a premium wage reflects a desire to minimize turnover, to retain workers who have received on-the-job training, and to avoid constant retraining of new hires.

Or, maybe the higher wages could derive from team-spirit, pride, or self-motivated dedication within the workforce, implying that higher pay leads to higher productivity rather than vice versa.

Finally, the wage premium may indicate that multinationals are sharing rents with workers, since under conditions of imperfect competition the value of what a worker produces is higher than what the output would be worth under competitive conditions. The potential of large international companies to share rents with low-skilled workers – that is, pay a wage equal to labor’s marginal-revenue product (ten shoes per hour sold at Nike prices, minus other costs) rather than labor’s marginal product (ten shoes per hour sold at generic prices, minus other costs) – will figure prominently in the discussion later in this Section of applying home-country pressure on multinationals to pay a “decent” wage.

In any case, the analytic mystery is not how multinationals get away with using their power to exploit workers but why they pay more than they “have to” to get the kinds of workers they need and want.

Do the higher wages paid by multinationals “spill over” into higher wages paid by indigenous firms in the host economy?
In Indonesia, Lipsey and Sjoholm found that the higher wages paid by foreign firms did translate into higher wages in domestically-owned plants. Holding labor force quality constant, they found a positive spillover within broad industry groups at the national level, and a smaller – but still positive and significant – spillover within narrower industry groups and at the province level.

In short, foreign investors consistently pay workers more than what comparable domestic firms provide, and sometimes this relative differential spills over to indigenous companies.

How do MNCs wages vary by sector, and by skill level?

Comprehensive wage data, collected with comparable methodologies across countries, do not exist. Information on benefits is even less systematic (in some sectors in some countries benefits, such as meals, uniforms, and access to medical clinics are a large proportion of total compensation; in others benefits are not).

The following wage information derives from diverse sources and diverse collection methods 1997-2000 (translated into 2005 dollars). The low end represents wages paid to an unskilled worker, the high end (where available) represents wages paid to a shift supervisor or foreman.

*Hourly Wage Rate (2005 dollars)*

**Electronics and Electrical Machinery**

- Thailand: $1.55-$9.11
- Mexico: $0.89-$11.76
- Philippines: $0.94-$6.77
- China: $0.78-$3.82

**Transportation Equipment, Machinery, and Industrial Equipment**

- Thailand: $0.91-$9.11
- Mexico: $1.81-$11.76
- Philippines: $1.15-$6.77
- China: $0.85-$3.82

**Textiles, Clothing, Leather, and Footwear**

- Thailand: $0.56-$0.87
- El Salvador: $0.95
- Philippines: $1.00
- China: $0.21

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104 Does not include benefits. See Beyond Sweatshops, Table 1-1.
Despite the limitations of data collection, it is clear that as foreign firms engage in more sophisticated activities they pay their workers two to three times as much, for basic production jobs, and perhaps ten times as much for more technical and supervisory positions. Thus a production worker in the Thai footwear industry might earn $0.56 per hour compared to $0.91 for a production worker in the Thai auto sector or $1.55 for a production worker in the Thai electronics sector (2005 dollars). Within the Thai auto sector, the wages climb from $0.91 per hour for a production worker to $9.11 per hour for a production supervisor. Similarly, within the Mexican auto sector, the entry level worker receives $1.81 per hour while a shift foreman earns $11.76 per hour.

The sharp rise in wages as the complexity of foreign investor operations increases takes on increased significance because – concern about “sweatshops” notwithstanding -- the globalization of industry is not concentrated in least sophisticated sectors.

FDI flows to relatively more advanced industrial activities in the developing world – in the transportation equipment, electrical machinery, chemical, computer, electronics, medical equipment, and other manufacturing sectors – are twenty times larger than to garments, textiles, leather goods, and toys. The accumulated stock of FDI is more than ten to one.

The predominance of multinational investment in middle-range industrial activities helps explain Rob Feenstra and Gordon Hanson’s somewhat counterintuitive finding about the impact of FDI on labor markets in Mexico. Contrary to the expectation that foreign investment would enter Mexico to exploit least-skilled labor (Mexico’s abundant resource), the principal result from a growing multinational presence has been to raise the demand for semi-skilled workers, and to enlarge the wage premium paid to them, as the foreigners plugged these workers into their international supply networks. In this process, the returns to basic education (e.g. completion of grade nine), and to work-experience, have grown for the Mexican workforce.

Over the life of NAFTA, wage gains have been largest in the regions of Mexico most exposed to international trade and investment. As US firms have moved their middle skill-intensive operations to Mexico, meanwhile, the average skill-intensity of production has risen in the United States as well as Mexico.

The result has been an increase in demand for, and earnings of, relatively higher skilled workers on both sides of the border.


Findings such as these will have an important place Section IV, which is devoted to analyzing the impact of outward investment on workers -- and on the composition of “good” jobs vs. “bad” jobs -- in the home economy.
Would Minimum Wages or “Living Wages” Serve Worker Interests?

The wages of a few dollars a day for least-skilled employees at foreign-owned and FDI subcontractor plants, reported above, cannot help but seem appalling to outsiders, even if these wages are higher than alternatives in the host economy.

Is there a way to push these wages up, without hurting the interests of the workers themselves? At first glance the task would appear daunting.

At the assembly level, as reported earlier, labor costs for jeans or athletic shoes range from a quarter, to half, to two-and-a-half times the profit margin at that stage. Plant managers are likely therefore to feel considerable pressure to find new sites where the combination of wage and productivity levels is most favorable.

A hypothetical minimum wage applied to countries with different productivity levels would force investor relocation from the lower to the higher productivity sites: a mandatory minimum wage of $2.58 per hour (in 2005 dollars) required of an employer to operate anywhere in Central America and the Caribbean -- which is the average in export processing zones in Costa Rica -- would lead foreign investors to abandon the Dominican Republic (where workers with lower productivity than Costa Rica receive approximately $2.06 per hour for the same kind of jobs), and force them to ignore El Salvador where productivity levels and wage levels ($0.70 per hour) are lower still.

For poor countries to use foreign investment to enter world markets, they must be able to make up for lower productivity through the payment of lower wages.

With this in mind, the living-wage movement has proposed that a minimum compensation package be set on a country-by-country basis, allowing the value of the package to vary across borders. The goal is to allow countries with lower-productivity workers to maintain their comparative advantage at foreign investment production sites. In each case, however, living-wage advocates propose that the minimum compensation package be set at a level high enough to support the worker and a family, and to provide some savings.

Drawing on experience in Mexico, the Center for Reflection, Education, and Action has proposed that the living-wage be set to meet the basic needs of one adult and one child. The National Labor Committee has recommended, in contrast, that the living-wage be calculated so as to support a family of 4.3 individuals, which is the average family size in El Salvador. A research group from Columbia University points out, however, that many garment and footwear employees in El Salvador return to rural households at night or over the week-end where average family size is 5.2 people, and consequently insist that this be the standard for calculating the living-wage.
But these calculations based on family size have the perverse impact of channeling the location of plants away from countries (and away from regions within countries) where the need for low-skill employment is greatest. An investor bound by living-wage obligations would search for sites where average family size were lowest in order to comply with living-wage requirements at least expense, and spurn the country of particular concern above -- El Salvador (especially rural El Salvador) -- entirely.

The more generous the calculation of the living wage, the more perverse the impact on poorer, less productive countries and regions.

Wage calculations based on family size rather than individual productivity are also inherently discriminatory. A firm’s obligation to pay every worker enough to support a family would curtail the availability of entry-level jobs for younger, single persons. A firm’s obligation to pay workers according to the differential family responsibilities of each -- separating out nuclear family-supporting, home village family-supporting, and self-supporting categories, for example -- would discriminate against those with larger families reliant on them. The predictable result would be that workers who needed a job the most would lie about their family status to get whatever employment were available.

Does this mean that civil society groups should stop pressing multinational companies to pay a “decent” wage (say, at least twenty-percent higher than the predominant wage among local firms)?

By no means! There is a major analytic difference between trying to force firms under highly competitive conditions at the assembly stage to raise their labor costs, and trying to push multinational corporations and retailers to ensure the goods they handle are produced at plants where workers are paid premium wages.

Multinational corporations and retailers have the potential to earn oligopoly rents. They have multimillion dollar advertising campaigns and endorsements devoted to creating a “brand image”, and multimillion dollar legal staffs to defend themselves against allegations of social irresponsibility (Nike’s annual expenditures on marketing alone reach nearly $1 billion). They have the potential -- and, as the evidence introduced earlier suggests, frequently the practice -- of translating some of their earnings into a wage premium at the production stage.

Moreover, international investors and retailers can act as a transmission belt for resources from final consumers. The fact that unit labor costs in assembly are a tiny fraction of the retail price (one percent or less for branded garments and footwear, two to three percent for generic garments and footwear) means that more generous wages and benefits for production workers will hardly affect the final price. The unit labor cost for a blazer retailing in the Spiegel catalogue for $99 is $0.84 in China, or 0.8 percent of the final sales price. The unit labor cost for an unbranded pair of jeans sold at Kohl’s for $21.99 is $0.66 in Nicaragua, or 3 percent of the final sales price. Either of these could be raised by twenty percent without the consumer noticing much difference. For their part, consumers indicate that they would be willing to pay

\[107\] Higher levels of required compensation lead to higher levels of youth unemployment. Lower-than-minimum wages -- called “apprenticeship” wages -- in contrast, significantly expand job opportunities for younger workers. WORLD DEVELOPMENT REPORT 2007: YOUTH UNEMPLOYMENT (forthcoming).
more for goods from plants that ensured good treatment for their employees ($1 to $5 additional for a $20 item).  

As a consequence, civil society pressure on multinational companies and retailers to show that their products came from plants with “decent” wages and working conditions – defined in terms of some increment, like twenty percent, higher than what local employers in a given country provide to workers of similar skill-level -- should not penalize poorer countries, less productive workers, or workers with large families if the costs were absorbed by the investors, purchasers, and consumers themselves. For plants that were owned by FDI subcontractors, the companies that control the supply chains could reward “decent” worker treatment through preferred purchase contracts and premium purchase prices.

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6. Worker Standards in Trade Agreements: From Bilateral Pacts to the WTO?

The United States has enjoyed some degree of success in using the provision of preferential access to the US market in bilateral trade agreements – as with Cambodia – to improve labor laws and government implementation of labor regulations in the partner countries. The threat of removing the trade preference in the event of poor performance, and the promise of rewarding good performance with greater access – backed by external assistance from the ILO in complying with good labor practices – have been effective levers to improve the treatment of workers.

Would the interests of developing countries – and their workers – be served by moving further, and inserting labor standards into the World Trade Organization (WTO)?

Is it feasible to ask the WTO to judge compliance with labor standards? Would such an outcome be desirable from the perspective of workers in developing countries?

Feasibility

For inclusion of labor standards in the WTO to be feasible, one would have to hypothesize that there were broad multilateral agreement on how to define the relevant labor standards, how to measure whether a state were devoting enough resources to meeting those standards, and how to determine whether observed outcomes constituted compliance.

The International Labor Organization’s Declaration on Fundamental Principles and Rights at Work defines the four core labor standards as freedom of association and effective recognition of the right to collective bargaining, the elimination of all forms of forced or compulsory labor, the effective abolition of child labor, and the elimination of discrimination in respect of employment and occupation.

A close examination the first of these -- freedom of association and right to collective bargaining, one of the oldest core labor standards, with a lengthy and detailed record of debate about what constitutes compliance — shows how far the world is from having the requisite consensus.

It might be comforting to think that decades of work by the International Labor Organization, the repository of multilateral investigation into allegations of labor standards violations for more than fifty years, would have left issues of definition and assessment of compliance thoroughly settled. But the reality is otherwise.

There is broad international agreement, for example, that governments should refrain from punishing workers who back their negotiations with employers with the threat to strike, and should have enforcement mechanisms in place to prevent employers from taking action against workers who do strike. This would logically seem to imply that labor legislation that permits employers to hire permanent replacements for striking workers contravenes this core standard. But ILO jurisprudence comes to no such conclusion.

Instead the ILO over the years has equivocated, acknowledging that the ability of employers to fill the positions of striking workers with permanent replacements “poses a risk” to effective
recognition of the right of collective bargaining but is not necessarily a violation of this standard unless it occurs on an unspecified “extensive” basis. The ILO lists the United States along with Burkina Faso, Cape Verde, Central African Republic, Djibouti, Madagascar, and Niger as countries with legislation that permits the hiring of replacements for striking workers.

Another problematic area involves laws requiring a “closed shop”, on the one hand, or the “right to work”, on the other. “Closed shop” laws permit collective agreements that make it compulsory that employers can recruit only workers who are members of trade unions and who must remain union members and pay union dues in order to keep their jobs. Conventional labor market analysis considers “closed shop” requirements as an infringement on the ability of workers not involved with a given trade union to engage in freedom of association.

With “right to work” laws, in contrast, the state guarantees the right of workers who do not participate in collective bargaining organized by unions, nor pay union dues, to obtain jobs that receive the benefits of the union’s collective bargaining. Such support for “free-riding”, in the analytics of social science, arguably constitutes a powerful indirect constraint on the ability of trade unions to organize workers effectively.

Here ILO jurisprudence again has left the basic issues unresolved, allowing both “closed shops” and “right to work” laws, as long as states do not impose by statute a particular trade union monopoly.

There are gaps in ILO treatment of freedom of association and right to collective bargaining. One of the more prominent is the possible control of unions by criminal elements. In some countries government officials or gangsters may organize unions as a protection racket, with employers recognizing the unions so that their store windows will not be smashed on a regular basis. Here ILO jurisprudence is silent, imposing no anti-corruption standard of conduct for union leadership. As a result, data showing high union density can be considered, despite widespread control of unions for criminal purposes, as evidence of a country’s respect for freedom of association and right to collective bargaining.

These illustrations of the problematic nature of identifying the specific obligations assumed by states in order to be in compliance could be amplified with reference to the other core labor standards.

Does respect for non-discrimination require provision of subsidized legal services to help with grievance actions or to protect those who file a complaint against retaliation? The strong presumption is that the answer is yes, but a judgment about what would constitute an “adequate” level of services or “adequate” amount of public subsidy could vary greatly depending upon a country’s particular circumstances.

Does compliance with non-discrimination prevent the use of explicit quotas (by race, religion, nationality, tribe or ethnic group) for hiring? While many member states consider explicit quotas to be anathema, ILO jurisprudence does permit their use to achieve numerical targets.

Is compliance with the forced or compulsory labor standard incompatible with private work programs in prisons, where participation in prison work programs is required as a condition of
parole, or incompatible with privatization of prison systems? ILO jurisprudence considers employment of prison labor by private contractors to be impermissible, but many governments (New Zealand, the United Kingdom, the United States) consider mandatory prison work programs and private contractors to be an integral part of modern management of penal institutions.

Coming to grips with what obligations are assumed by a country that pledges to adhere to a core labor standard is only the first step. Next comes the task of finding indicators, or targets of investigation, that might show whether a country is in compliance, or not.

The first level for investigation involves an appraisal of a given country’s legal framework relating to the core labor standard; that is, for example, whether laws and regulations protect freedom of association, right to collective bargaining, and right to strike within the assessor’s understanding of the country’s obligations in this regard.

The second level of investigation involves an appraisal of governmental performance in implementation of the standard in a given country, looking both at effort and effectiveness; that is, for example, whether the government is devoting enough attention to protect organizing, bargaining, and striking, and whether in so doing the government is generating an acceptable level of results.

Along both dimensions of government performance – effort and effectiveness – the resulting evaluation will depend upon the resources available to the government, and the urgency of competing claims on those resources (e.g. to deal with HIV/AIDs or to provide potable water). Since the level of development and the competing needs faced by the government will limit what might be able to be devoted to enforcing compliance with core labor standards, the evaluation of compliance will have to involve a decision about whether and how much to discount the inputs and outcomes to account for these factors.

In the contemporary world, the degree to which a country can be “forgiven” for low levels of public sector inputs or poor public sector results due to the country’s poverty and/or competing need for expenditures elsewhere – whether for freedom of association, child labor, forced labor, and discrimination – would be almost entirely subjective.

These complexities have rather striking implications for the feasibility of conditioning the provision of trade advantages upon verdicts of guilt or innocence in complying with core labor standards.

Even assuming gallant efforts at “due diligence”, thoroughness, and dispassionate evaluation, it becomes clear that the world is far removed from having the consensus that could serve as the basis for a multilateral jurisprudence – path-breaking past work of the ILO notwithstanding -- to decide cases that could be backed by sanctions, such as denial of trade benefits or fines.

It is hard to imagine how to instruct members of trade dispute settlement panels – or subsequent appellate bodies -- so that they could render consistent verdicts of guilt or innocence in any but the most widely accepted, clear cut, and egregious cases of violations of a core labor standard. Even then, any effort to formulate a multilateral jurisprudence for use in trade-and-labor cases
would surely require fundamental substantive changes in labor law in developed as well as developing countries, not least the United States. The United States would discover that not only does it have to ratify five of the basic ILO conventions that have never even been submitted to Congress, but it would have to rewrite state and federal labor regulations to bring the country into compliance.

**Desirability**

Nonetheless, making a heroic assumption that agreement on meaning, effort, and compliance might be negotiated at some point, would placing labor standards with the WTO be desirable from the perspective of developing country workers?

The answer requires investigation of how penalties – once guilt were determined – might be imposed.

Within the WTO enforcement system, a member state may file a complaint against another member for an alleged violation – in this case, an alleged violation of one of the core labor standards – triggering an investigation and dispute settlement panel. If the investigation substantiated that a violation or pattern of violations had occurred, and if the dispute settlement procedure failed to bring the violator into compliance, the country/countries filing the complaint are allowed to suspend their WTO obligations to keep their markets open, and to retaliate against the violator by blocking imports.¹⁰⁹

Where should the retaliation be directed?

One option would be to permit retaliation at the plant level where violations of labor rights took place. This in essence allows the multinational community to inflict pain upon the firm that operated with low labor standards by refusing to accept exports from that plant. The outcome is likely to have the effect of punishing the victims as their plant closes or the workers are laid off.

A second option would be to permit retaliation across the entire sector where labor violations were found, such as all footwear plants in a given country. This would be a more potent penalty, but it would constitute a verdict of “collective guilt” that lumped investors and subcontractors with good records with investors and subcontractors without. Socially responsible companies that were pulling worker treatment upwards would be hit in the same way as non-compliant companies that were pulling worker treatment downwards. A pernicious consequence would be that multinational corporations around the world could no longer promise their own managers, or their subcontractors, that they would enjoy reliable purchase orders as long as they observed high labor standards.

A third option would be to permit retaliation across diverse sectors – as the WTO currently does – allowing the winner of a WTO dispute to select where the pain imposed upon the violator will impart the most agony. As now practiced, this would allow the winner of a dispute to block imports of auto parts, electronics, chemicals, and medical devices in order to force better worker treatment in plants making ball caps with college logos on them. A system such as this would put at risk the transformation of worker treatment described earlier as foreign investors engage in ever more sophisticated manufacturing activities.

¹⁰⁹ Or perhaps – looking to the future -- impose fines, and block exports if the fines are not paid.
Worse, a system such as this could easily fall prey to protectionist manipulation as medium-skilled industrial workers and firms in developed countries in the sectors named in the illustration above -- auto parts, electronics, chemicals, and medical devices -- discovered how to use WTO labor complaints involving garments and footwear to stop imports of developing country products that competed with their industries.

Thus, a close look at how a hypothetical WTO-based labor-standards enforcement mechanism might function shows that the system would be fraught with dangers to developing countries and their workers.
7. FDI and an Upward Path for Poorer Developing Countries

Foreign investment cannot be expected by itself (and in isolation from other economic, educational, institutional, and health factors) to generate growth, or be a cure-all for the problems of poverty, in low-income developing countries any more than in middle-income developing countries.

But the country studies presented in these first two Sections show a clearly visible path whereby developing countries can harness foreign direct investment in progressively more important ways to contribute to their growth and welfare.

Poorer countries can look to Madagascar, and Lesotho for examples of how to get launched.

Countries that replicate the experience of Madagascar and Lesotho can look to Mauritius and the Dominican Republic for examples of how to diversify their foreign investment base out of least-skilled operations like garments and footwear.

Countries that replicate the experience of the Mauritius and the Dominican Republic can look to Costa Rica, Mexico, Malaysia and Thailand for examples of how to move toward increasingly higher skilled operations like auto parts, semiconductors, and business services, with expanding layers of indigenous suppliers and increasingly robust spillovers to the local economy.

Countries that replicate the experience of Costa Rica, Mexico, Malaysia, and Thailand can look to Singapore, Portugal, and Ireland for more complex and expansive development options.

This path follows what might be called a “build up” approach to strengthening the host country economic base rather than a “trickle down” approach of channeling rents to privileged recipients. A “build up” strategy has a macroeconomic dimension that supports domestic as well as foreign firms with low inflation and a realistic exchange rate, a microeconomic dimension that rewards saving and investment, and an institutional dimension that provides regulatory and legal stability with a minimum of red tape and corruption.

A “build up” strategy provides domestic as well as foreign firms with reliable infrastructure services. A “build up” strategy offers domestic as well as foreign firms access to inputs at internationally competitive prices. Finally, a “build up” strategy makes available broad-based access to vocational training and skill-development for workers and managers in domestic as well as foreign firms.

A “build up” strategy depends upon continuously greater liberalization of the economy. It does not involve separate and differential – more sheltered or more protective – treatment for low-income developing states than for middle-income developing nations.

This path exposes host countries to ever-larger flows of FDI as investors move from least-skilled to middle-skilled operations, with steadily higher wages and better treatment for workers, and greater opportunities for national firms to become suppliers to or competitors alongside foreign companies. Even in the early stages, as the cases of Mauritius and the Dominican Republic showed, the goal is not only to attract foreign corporations but also to create the beginnings of an energetic national business community, with experience in meeting standards of quality and price required by open markets and in taking risks to achieve success, rather than relying on favors to protect themselves from competition.
Section III

FDI in Extractive Industries and Infrastructure

Foreign direct investment in natural resources can have a formidable impact on the economic prospects of a developing country.

A typical petroleum well complex producing 100,000 barrels per day in 2005 generated more than $2 billion in exports, with potential government revenues – depending upon production cost and tax structure – of more than a billion and a half dollars for the host authorities.

The expansion of investment in the Argentine mining sector in recent years allowed mineral exports to overtake the country’s legendary beef shipments in 1998, and – at $5 billion per year – double the value of beef exports by 2002. Argentina’s goal has been to overtake Chile, whose copper production reached $8 billion in 2004.

A single investment of $1.3 billion in the Mozal bauxite smelter in Mozambique, completed in 2000, almost equaled the country’s entire gross domestic product ($1.7 billion), and increased the country’s total exports twice over. Phase 2 of the Mozal project, currently underway, will more than double capacity by 2007.

In infrastructure, private (or privatized) enterprises in developing countries have delivered performance superior to state-owned utilities, on average, over the past thirty years. The attraction of private investment – often foreign private investment – in infrastructure enhances the competitiveness of firms and expands employment throughout the economy. Reliable transportation systems and power sources allow companies to reduce inventories and eliminate expenditures on backup generators. Each one percent increase in the number of telephone lines per worker may raise a country’s growth rate by one-fifth of one percent.

Private ownership of infrastructure can increase access to water, sewerage, and electricity for poor people. Provision of electricity to those with no formal education rose in three of four Latin American countries after privatization. Privatization of local water companies in

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113 John Nellis, Rachel Menezes, and Sarah Lucas, “Privatization in Latin America: the rapid rise, recent fall, and continuing puzzle of a contentious economic policy”, Policy Brief, Center for
Argentina lowered child mortality by five-to-seven percent in municipalities that privatized their water services compared to those that retained public services. In the poorest districts, privatization of water services led to a twenty-four percent reduction in child deaths by infectious and parasitic diseases caused by dirty water. In Bolivia, the sharply rising access to telephone lines after privatization has been concentrated among lower-income users.

Yet privatization of infrastructure and foreign ownership of power grids, water networks, telecom systems, roads and port facilities continue to be among the most controversial areas of host country policy. Public reaction to rate increases is highly charged and hugely potent politically.

Foreign investors in infrastructure and extractive industries are among the most widely accused of bribery and corruption. In the oil and mineral sectors, potential revenues that might be dedicated to host country development frequently go unaccounted for. An abundant natural resource endowment is often considered a “curse” – rather than a blessing – fueling rent-seeking societies, dictatorships, wars and civil strife.

Across all types of FDI, contracts and concessions to foreigners in natural resources and infrastructure have proven to be the most unstable. As a result -- to protect themselves before they make large sunk investments -- foreign firms have been demanding new and greater kinds of international and multilateral contract protection, shifting new and often unanticipated risks onto host authorities.

What kinds of policies to promote foreign direct investment in natural resources and infrastructure serve the interest of host economies in the developing world, and what kinds of public sector policies have proven to be ill-advised or harmful?

What kinds of surveillance and transparency can reduce corruption and favoritism in the award of contracts and concessions, and prevent diversion of revenues into private hands? How successful are current initiatives proving to be?

The answer to these questions must be found not only in the policies of developing countries themselves, but also in the policies of developed countries and multilateral institutions.

This Section therefore begins the assessment – continued in the concluding Section V – of how both developed countries and developing countries can work together to facilitate flows of FDI that benefit developing countries, and not facilitate (or prevent) flows of FDI that do not.


1. Market Failure and FDI in Natural Resources and Infrastructure

The analysis of what kinds of public policies are needed to facilitate foreign direct investment in natural resource and infrastructure follows a dialectical path in this Section, first laying out a rigorous justification for public sector intervention in general, then revealing how current interventions have gone too far.

As Sections I and II noted, the list of factors that international companies consider detrimental to investment is long and varied. In the case of extractive industries and infrastructure, one impediment stands out – breach of contract.

In principle, all of the foreign investment in manufacturing and assembly examined earlier might too be subject to breach of contact, or contract frustration. But companies that have relatively small sunk capital are able to threaten to withdraw if host authorities propose harsh changes in treatment. Companies that utilize rapidly changing technology find that provision of the newest practices gives them a card to play (to offer, or to withhold) in their relations with host authorities. Companies whose products enjoy considerable product differentiation have been more immune to host country demands than companies whose local products are marketed as “commodities”.

Investors whose projects require large fixed investments, utilize (ostensibly) stable technology, and produce output without a large degree of brand identification, in contrast – like natural resource companies and power plant operators or water utilities – find themselves particularly vulnerable to host country decisions to change to rules under which they operate.

Over the course of history, host country “renegotiations” were aimed in the first instance at demanding greater host country ownership – minority host country participation, majority host country participation, and ultimately nationalization. While the threat of nationalization has not disappeared – especially in infrastructure projects – the more frequent area of contention in the contemporary period has been host country demands for contract revisions that do not necessarily involve changes in ownership.

Initial efforts to understand developing country propensities to alter solemn contracts that they signed with foreign investors – to raise tax rates, to change accounting rules (such as accelerated depreciation or expensing provisions that seriously affect the profitability of foreign investor operations), or to revise regulatory agreements and procedures -- attributed this phenomenon simply to “opportunistic” behavior on the part of nationalistic or populist host country authorities.

What Raymond Vernon first called the “obsolescing bargain” model, however, suggests that there is a dynamic in the evolution of the business-government relationship in natural resource

and infrastructure investment that goes well beyond random opportunism on the part of host
country authorities.116

In the “obsolescing bargain” model, changes in the level of commercial risk associated with a
given project, and changes in the evaluation of the unique benefits investors bring, drive both
sides toward an unstable relationship. Investors (and their financial backers) will not commit
capital to a project unless those resources receive compensation commensurate with the initial
uncertainties to which their money is exposed. For any given project, the investors cannot avoid
demanding generous terms when the initial risk and uncertainty are high; they cannot avoid
asking that potential winners pay for potential losers across their entire portfolio of projects.

Host countries agree to these terms in order to attract the investment, but once the project is
successful they do not want to compensate investors with the same generosity long after the
initial risk and uncertainty have dissipated; they do not want the returns from projects in their
country to make up for the parent company’s failures elsewhere. Host governments are highly
prone therefore to demand that the terms of the investment agreement be revised.

If the host authorities who entered into the original investment agreements do not engage in this
behavior, subsequent governments may. Economic self-interest may be backed by nationalistic
indignation that the original negotiators “sold out” the country, offering too generous
concessions. Allegations of corruption – founded or unfounded – may appear, as discussed later
in some detail.

To cope with this dynamic, those public officials who sign natural resource and infrastructure
concessions can “cross their hearts” – in Thomas Shelling’s characterization – that the
experience in their country will be different.117 But in reality they are unable to make a credible
promise that the agreement will be honored. The “obsolescing bargain” represents a classic
example of market failure due to imperfect contracts. Left unchecked, this leads to systematic
under-investment from what would best support the living standards and growth prospects for
the countries involved.

The dynamics of the “obsolescing bargain” present a challenge that investors, lenders, and
insurers are not well equipped to address on their own. For private natural resource and
infrastructure investors, and private financial institutions that lend them capital for their projects,
conventional analysis of what to do in the face of the “obsolescing bargain” carries them in a
strategic direction that is actually counterproductive.

The most frequent response to the presence of political and regulatory risk is for investors and
their financial backers to insist upon a higher risk premium to be reflected in the initial terms of a
project. But the problem posed by the “obsolescing bargain” is not the lack of generous
treatment at the front-end of a long-term investment, but rather the propensity of host authorities


– often successor host authorities to those who signed the original investment agreement – to tighten the terms and conditions after the project has proved successful.

A demand for yet more favorable conditions at the start may only hasten a later backlash along “obsolescing bargain” lines – a form of self-fulfilling prophecy.\(^\text{118}\)

Credibility in honoring commitments is the centerpiece of being able to engage in strategic negotiations. Lack of credibility is sufficiently costly that strategic negotiators across many fields of human endeavor – including past nuclear arms negotiations – seek out external mechanisms to demonstrate that they have bound their own hands (and the hands of their successors) to enforce their own promises.\(^\text{119}\) In the absence of such credibility, the ability to negotiate mutually beneficial agreements falls far short of what is socially optimal.

In bargaining theory, actors may exchange hostages to enhance the credibility of their commitments, or they may deliberately leave high value assets at risk to adverse action by the other side (as in “mutual assured destruction”), or they may provide an extended warranty (“promise to fix”) with assets in escrow to cover possible repair costs. The decision of a host country to sign an agreement with public sector (national and multilateral) guarantors, and to allow public sector (national and multilateral) guarantors to participate in potentially sensitive projects, can be conceptualized as a willingness to leave high value assets at risk to action by the other side in response to the breaking of an agreement by the host, or as a willingness to provide a lengthy “promise to fix”.

This analysis provides the justification for public sector intervention to correct for market failure. It helps put the role that public sector (national and multilateral) guarantors – distinct from the role of private political risk insurers and financial guarantors – into perspective.

Whereas private sector political risk insurers can provide the prospect of compensation to their clients, public sector (national and multilateral) guarantors can provide deterrence as well as compensation. That is, the participation of a multilateral insurance agency like the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group or a national political risk insurance agency like the US Overseas Private Investment Corporation (OPIC) in a project may help dissuade a host government from taking adverse actions toward foreign investors because the host wishes to remain on good terms with them, and in most cases has signed an indemnity agreement with them.\(^\text{120}\) The involvement of multilateral or national political risk insurers aids in overcoming the inability to make credible commitments about the treatment of foreign investors by helping host authorities to “bind the hands” of themselves and their successors.


But – however well-justified the principle of public sector intervention to guarantee contracts can be demonstrated to be -- the pendulum may now have swung too far in the direction of providing uncritical support for FDI in natural resources and infrastructure. The past decade has shown the emergence of important new problems associated with using national and multilateral insurance agencies to enforce the stability of natural resources and infrastructure agreements.
2. Reform in Official Protection for Infrastructure and Natural Resource Investors

What has gone awry in providing official protection for infrastructure and natural resource investors?

The most important “new problems” that have emerged involve separating political from economic risk, dealing with financial-crisis contagion, amending commercial law arbitration procedures, overcoming moral hazard, and avoiding “excessive” contract stability.

While it may not yet be possible to determine exactly how to resolve these “new problems”, the first step is to identify the nature of the challenges in each area, and the general direction in which debate about new solutions must proceed.

*Political versus Economic Risk, and Financial-Crisis Contagion*

Looking first at infrastructure, there has been a growing appreciation -- since the Asian financial crisis in the late 1990s -- of the need to reevaluate which parties should be required to absorb commercial risks associated with fluctuations in supply and demand for services, and with fluctuations in exchange rates.

Over the course of the 1990s, foreign investors in the power sector had begun to insist – as a condition of making an investment – that host authorities make major commitments to supply inputs, or purchase outputs, and to guarantee the conversion value of payments made in local currency. As long as host country economic growth remained robust, and demand for electricity grew at 8 percent per year (or more), these projects were highly beneficial for the domestic economy while yielding rates-of-return on the order of 30 percent per year to the foreign sponsors.

But who should bear the costs of adjustment for projects whose underlying assumptions proved far too optimistic, or whose timing coincided with adverse fluctuations in the world economy?

Following the legal logic of the investment contracts involved, when host authorities found themselves unable to meet their commitments due to downturns in the economic environment, the resulting defaults came to be considered political acts (*unwillingness* to make good on obligations) rather than commercial acts (*inability* to make good on obligations).

In Indonesia, for example, a US investor, the MidAmerica corporation, signed agreements in the mid-1990s to build geothermal power projects on the basis of take-or-pay power purchase agreements with the state-owned utility (Perusahaan Listrik Negara, or PLN). The Ministry of Finance of the Indonesian central government provided a support letter, pledging that it would cause the state-owned oil and gas corporation (Pertamina), and PLN, to honor and perform their obligations under the agreements for these geothermal projects.

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With the spread of the Asian financial crisis in 1997, the government of Indonesia was forced to reduce government spending drastically, as a condition of receiving financial support from the International Monetary Fund, the World Bank, and the Asian Development Bank. Indonesia, like other Asian countries, found itself committed to power projects and power capacity that it did not need and did not have the financial wherewithal to pay for, a predicament brought about by forces external to its own macroeconomic management.

As part of the budget cutbacks, the government of Indonesia issued a decree dividing all infrastructure projects undertaken by or in conjunction with any state-owned entity into three categories: those to be continued, those placed under review, and those postponed. In 1998 MidAmerican’s projects were placed under review, and, when PLN failed to accept and pay for the electricity, MidAmerican pursued its rights under arbitration.

In 1999, two consecutive arbitration panels found PLN in breach of contract, ordering Indonesia to pay damages immediately in hard currency, implicitly granting satisfaction for aggrieved investors precedence over all other import needs. The failure of the government of Indonesia to comply obliged the US Overseas Private Investment Corporation – that had provided political risk insurance to MidAmerica -- to make one of the largest payments ever awarded ($290 million of the arbitrators’ total judgment of $572 against Indonesia). OPIC thereupon began to pursue the government of Indonesia for full recovery.

Political risk has traditionally been defined in terms of deliberate acts by host country authorities motivated by an intention to change the treatment of a foreign investor. Changes in external market conditions over which host country authorities have no control that reduce their capability to perform as expected, in contrast, might better be considered to fall under the rubric of commercial risk.

But national and multilateral political risk insurers have allowed the line between commercial and political risk to become blurred, in the judgment of Charles Berry of the Lloyd’s firm Berry, Palmer & Lyle, ignoring the distinction between intent and capability. In fact, more than 90 percent of the political risk losses paid by Lloyds syndicates in recent years have occurred when a public sector buyer or supplier was unable to meet all of its obligations on time and in full. The resulting default could be attributed more often to economic misjudgment or over-commitment on the part of host country actors, according to Berry, than to bad faith with regard to contractual obligations.


The implications of using national or multilateral political risk insurance to guarantee take-or-pay contracts with parastatal entities has been compounded when the infrastructure rates have been denominated in dollars for payments received in local currency. Official political risk insurers that had refused to provide explicit exchange rate protection suddenly discovered that they were exposed to vast exchange rate liabilities.\(^\text{124}\)

What is needed is a reevaluation of how to prepare for project difficulties that spring from cross-border financial contagion rather than from deliberate host country misbehavior, and how to separate genuine political risk from more general commercial risk during a regional economic downturn.

To accomplish this, public sector political risk insurers might contemplate a kind of “force majeure” exception to deal with economic and financial contagion, recognizing that such an exception would have to be crafted narrowly so as to avoid governments routinely claiming that “forces beyond their control” allowed them to repudiate their contracts.

In a study of thirty three infrastructure projects in twelve countries, between 1990 and 2005, Erik Woodhouse found that the contracts associated with thirteen projects held, eleven underwent mutual or cooperative renegotiation, and nine experienced unilateral renegotiation or nonpayment (of which four ended in arbitration or litigation).\(^\text{125}\) The eleven that underwent cooperative renegotiation involved refinancing project loans, restructuring of changing fuel supply provisions, or identifying other elements of the original contracts that could be mutually changed. In these eleven renegotiations the movement of both sides to some kind of “work out” did not imply a sell out of either the investor or the host.

The four that ended in arbitration or litigation all concerned host government attempts to void or alter the contracts in the aftermath of some macroeconomic shock, and turned on some variant of the claim that a dramatic change in circumstances provided a defense to strict enforcement of the contract. In each case the government party advancing the claim of hardship or changed circumstances specified that it was not able to foresee at the time of signing, and involved events beyond its control.

Problems with Commercial Law Arbitration Procedures

Political risk claims arising in the midst of regional or international financial crises -- in Russia and Latin America, as well as Asia -- have also led to reassessment about whether commercial


law arbitration procedures constitute a suitable mechanism for dealing with many kinds of contemporary infrastructure investment disputes.

Political risk insurance or guarantee contracts from national and multilateral agencies typically require that before making a claim the investor must exhaust commercial law arbitration procedures for the settlement of investor-host government disputes, utilizing ICSID (International Center for the Settlement of Investment Disputes) and UNCITRAL (United National Center for International Trade Law).

The development policy community has traditionally applauded the use of arbitration to settle investment disputes, but only belatedly come to realize that resort to ICSID or UNCITRAL is in no sense like an appeal to an international Supreme Court to decide what best serves the public interest.

Quite to the contrary, these arbitration procedures focus deliberately on the most narrow issues of contract compliance, and – as in the case of the MidAmerica in Indonesia – are likely to place a foreign exchange payment to a foreign investor ahead of every other funding priority, including importation of food and medical supplies for a population in the midst of crisis.

It is not plausible to expect host authorities in dire straits to make payment of an arbitral judgment before all else. Nor is it good public policy. Contract enforcement needs to be part of the medium-term “work-out” arrangements that balance the needs of all parties.

The reconsideration of commercial law arbitration procedures should devote attention to the appropriate determination of the size of awards, as well. In current practice, arbitrators often award investors the full amount they have put up plus a large fraction of the net present value of future earnings (up to 30 years, in some cases), even for projects that have not been completed or proved successful.

What would happen in a developed country, asks Louis T. Wells, Jr., if a home owner signs a contract with a painter but the house burns down before the painter completes – or even begins – the work. The painter would never insist on the right to continue painting the charred remains, nor would the owner be obligated to pay the full amount of the contract. Instead, a judge might decide that the owner had to pay for the paint already purchased, for the labor already expended, and perhaps for some additional wage cost until the laborers were redeployed.

This hypothetical comparison may be overly vivid, but it points in a reasonable direction for infrastructure coverage, namely, that official political risk insurance coverage be made only for a fraction of the investment, that awards represent only partial reimbursement, and that compensation not envision payment of the full stream of revenues over the life of uncompleted and untried projects.

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These recommendations would help address a further problem that has appeared – moral hazard for infrastructure investments.

**Moral Hazard**

During the Asian financial crisis, it became apparent that international power companies that were covered by official political risk insurance were behaving differently from those that were not. The MidAmerica parent company cited above moved immediately for enforcement of its contracts. Other investors in the same predicament – but without multilateral or national insurance coverage – decided to negotiate a work-out with host authorities. Unocal and Jawa Power, for example, took the route of restructuring their contracts with the Indonesia government to follow a new timetable for bringing the power projects on-line as the host economy recovered.

The tendency of arbitral panels to provide overly generous awards as outlined above reinforces moral hazard in a perverse manner. Besides tilting the investor toward demanding compensation rather than engaging in a work-out, the promise of lucrative compensation tempts an investor to bail out of an investment once it becomes apparent that the original surrounding assumptions were too rosy. This protective legal structure not only skews the choices facing the investors themselves, but also affects the behavior of their financial backers -- as when the banks lending to infrastructure projects in Asia refused to authorize the investors to restructure the original package.

**“Excessive” Contract Stability**

Finally, there are legitimate questions about whether public sector political risk insurance can provide “excessive” stability over the life of long-term infrastructure and natural resource concessions.

Throughout the interaction between investors and host authorities in both infrastructure and extractive industry projects -- in the “obsolescing bargain” model -- there are legitimate questions about how long investors in admittedly risky projects should receive a return that reflects the opening risk premium once the project is successful. Similarly, there are legitimate divergences between investors who want “winners to pay for losers elsewhere” and host authorities who do not want to be stuck with terms designed to compensate the investors for mismanagement or mistreatment in other projects and other countries.

Should the terms of infrastructure and natural resource investments ever be open to renegotiation? Are the initial agreements always to be sacrosanct for the duration of the concessions?

In what has become a notoriously controversial infrastructure contract dispute, for example, an Enron-led investor group proposed to supply electric power to the state of Maharastra in India from the Dabhol generating station, beginning in 1996.\(^{127}\) Anticipating rapidly growing demand for electricity, the Maharashtra government agreed to set local electricity prices to ensure a rate

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\(^{127}\) Harvard Business School, “Enron Development Corporation: The Dabhol Power Project in Maharashtra, India,” *op. cit.*
of return of 25.22 percent to the foreign investors each year for twenty years, guaranteed in dollars, for local payments made in rupees. The take-or-pay contract committed Maharashtra to buy 90 percent of Dabhol’s peak-capacity output over the twenty year period.

A subsequent Maharashtra government objected that this contract was imbalanced in imposing all risks associated with fluctuations in electricity demand, and fluctuations in currency values, on local authorities, so as to ensure the Enron-group received an “excessive” rate of return. In repudiating the contract, the state government also alleged corruption in the awarding of the contract, which had been signed without competitive bidding on the project, nor on the construction and equipment purchase contracts.

Similar disputes about how long an initially generous investment structure should last have plagued natural resource investments as well. In the first round of oil concessions in Kazakhstan in the mid-1990s, Chevron Texaco, TotalFinaElf, and other foreign investors helped the host country draft the sections of the post-Soviet legal system governing the energy sector. At the time of this assistance, the Kazakh negotiators had such a limited understanding of the workings of the external world they “did not know where Paris was” – in the words of an American oil executive. For this and subsequent quotations, see Sabrina Tavernise with Christopher Pala, “Energy-Rich Kazakhstan is Suffering Growing Pains”, New York Times, January 4, 2003, p. C 3.

After the discovery of more than nine billion barrels in reserves, and with increased indigenous and consultant-provided sophistication about tax and accounting structures, Kazakh authorities changed the accounting rules (removing accelerated depreciation) in 2003 to increase the tax burden on the companies.

The foreign firms with sunk assets claimed that the original contracts were “sacrosanct”, and the US government agreed “you cannot change the rules of the game after people have invested.”

The Kazakh authorities countered by characterizing the original contracts as giving the foreign investors “everything they wanted in exchange for beads”. They also alleged corruption on the part of those companies that procured the initial concessions.

Leaving aside the allegations of corruption in procuring the concessions – which will be dealt with in detail next in this Section – should the terms of the initial contracts always be maintained without alteration over the lifetime of the infrastructure or natural resource projects?

Or might there be a point at which preoccupation with the stability of contracts becomes “excessive”?

The concern about “excessive contract stability” is reinforced for infrastructure investment by recalling that public sector commitments are made within the context of a given technology base, whereas innovation in the industry proceeds apace, possibly leaving the country stuck with high cost power or old-fashioned telecommunications services.

If host obligations take the form of guaranteeing the supply of an input or the purchase of an output, they may cut off the possibility of new entrants into the industry, and, paradoxically,
reduce the options available to alternative investors.\textsuperscript{129} They also reduce the inventive for the original investor to upgrade facilities. And, ultimately, as in any take-or-pay contract, the government has to make good on whatever payments have been promised despite external fluctuations in supply and demand.

In the Philippines, for example, several of the small and relatively inefficient power plants constructed to respond to the electricity shortage of the early 1990s could easily have been replaced with larger, more efficient modern plants, but the older system was kept in place by government guarantees standing behind 20-year off-take agreements.

A regulatory system to cover infrastructure owned by international investors should have to meet the same three goals as regulatory systems that cover only domestic investors, namely inducing investment at a reasonable cost of capita, providing incentives for efficiency in investment and operation, and ensuring a reasonable amount of flexibility to adapt to changing conditions and circumstances. And, if the regulations require that the government compensate every participant fully for the effects of every rule change, the end result will be very little flexibility for policy improvement.\textsuperscript{130}

At one point, in the mid-1990s, the OECD’s CIS Expert Group on Foreign Investment, for example, seemed to take a tentative step in the direction of permitting renegotiations of investment agreements, or, to be more precise, of placing a limitation on the prohibition of renegotiations, once ten years have passed.

In its recommendation on “Stability of Investment Regime” (Article 12, no. 2, 1995), it stated: “If any provision whatever of the Law or any special advantage granted to a Foreign Investor is changed or repealed to the detriment of such Investor before the expiry of ten years from the moment of the making of the investment, unless provided otherwise in the act creating such special advantage, the Investor shall have the right to demand compensation for any loss incurred as a consequence of such change or repeal.”\textsuperscript{131}


\textsuperscript{130} While it is beyond the scope of this volume to assess the debate within international law about what regulatory actions constitute a “taking” of a foreign investor’s property, it is useful to note that the United States has moved in the direction of narrowing the interpretation of when regulatory changes (e.g. new environmental regulations) might be considered expropriatory. The US-Central America Free Trade Agreement (CAFTA) states that normal regulatory measures should “rarely” be judged to constitute expropriation, but does not define those rare circumstances in which they might be so judged. US-Central America Free Trade Agreement, 2005, Annex 10-C.

In the same vein, an assessment of how the Overseas Private Investment Corporation might be reformed to meet the challenges of the 21st century raised the question of whether OPIC should shorten its standard twenty-year guarantee against breech of contract.\textsuperscript{132}

But neither limitation on contract duration nor enunciation of a “right of renegotiation” in investment agreements has ever attracted the support of the international investor community. Instead, investors insist that contracts must be honored as a matter of principle (pacta sunt servanda).

But this stand on principle is somewhat disingenuous since – according to calculations carried out by Luis Gausch -- private investors are in fact responsible for the larger proportion of contract changes (61 percent of all renegotiations) over the life of their projects, in comparison to host authorities, at least for infrastructure investments in Latin America and the Caribbean.\textsuperscript{133} Data from 942 infrastructure concessions, stretching from the mid-1980s to 2000, reveal a pattern in which investors frequently underbid to acquire the concessions and then seek to alter the terms in their favor afterwards. Host governments initiate less than half as many renegotiations (26 percent of all renegotiations), with the rest taking place when both sides seek renegotiation.

\textsuperscript{132} Reforming OPIC for the 21st Century, op. cit.

\textsuperscript{133} J. Luis Guasch, op. cit. Table 1.13.
3. Combating Bribery and Corrupt Payments, and Ensuring Transparency in the Payment and Disposition of Natural Resource Revenues

An appraisal of how FDI in natural resources and infrastructure might be structured to provide most benefit – and least harm – to host country development demands that special attention be devoted to measures to control bribery and corrupt payments in the awarding of concessions, and – especially for extractive industries – to prevent diversion of revenues that should be used for public purposes into private hands.

Efforts to Control Bribery and Corrupt Payments in Awarding Contracts

Allegations of bribery and corrupt payments have a long history in the awarding of oil and mining concessions, and in the bidding for infrastructure projects. Until 1996, in fact, many developed countries considered bribes paid abroad a normal cost of doing business, and routinely allowed multinational corporations to deduct such payments to host government officials, or their friends and family members -- in order to secure contracts and investment concessions -- as a legitimate business expense.

The United States considered itself --somewhat self-righteously\(^{134}\) -- more virtuous than others, having passed the Foreign Corrupt Practices Act in 1977.

In 1996 the OECD published Tax Recommendations on the Non-Deductibility of Bribe Payments, and in 1999 the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions entered into force. Since 1999, Phase 1 of a monitoring process has begun to examine each OECD country’s legislation to assess whether the standards of the Convention have been adequately transposed in national law. This produces recommendations, whose adoption is in turn monitored. Phase 2 then studies the structures and institutional mechanisms in place to enforce the implementing legislation.

As of January 1, 2005 eighteen countries had completed Phase II exams (Bulgaria, Canada, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Japan, Korea, Luxembourg, Mexico, Norway, Switzerland, United Kingdom and Northern Ireland, United States), and eighteen more countries had scheduled Phase II exams to be completed by 2007 (Argentina, Australia, Austria, Belgium, Brazil, Chile, Czech Republic, Denmark, Ireland, the Netherlands, New Zealand, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Turkey).

What is the effectiveness of OECD home country regulations to prevent bribery and corrupt payments on the part of multinational firms?

The number of capital-exporting countries reporting major investigations of possible bribery and corruption has remained quite low – only two of the twenty-one largest developed countries in 2003-4 indicated they were examining prominent home country multinationals for possible

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\(^{134}\) Response of the US Department of State to the “investment flows” questionnaire of the FOREIGN POLICY-Center for Global Development Commitment to Development Index 2003-4.
infractions. This contrasts sharply with the testimony of companies and business groups about the practices of firms in the infrastructure and natural resource sectors in developing countries.

Transparency International’s survey of 835 senior executives of international and domestic companies, chartered accountancies, bi-national chambers of commerce, and commercial banks and law firms in 2001-2 placed oil and gas as the sector where the third largest bribes were likely to be paid (behind public works, and arms and defense) and power generation as the sector where the seventh largest bribes were likely to be paid.

The 2002 Bribe Payers Index, constructed by Transparency International on the basis of the results of this survey, in fifteen developing or emerging-market countries (including Argentina, Brazil, Colombia, India, Mexico, Nigeria, the Philippines, Russia, South Africa, and Thailand), suggested a relatively low likelihood to pay bribes on the part of firms from Australia, Sweden, Switzerland, Austria, and Canada, a higher likelihood to pay bribes on the part of firms from the Netherlands, Belgium, United Kingdom, and Germany, and a still-higher likelihood to pay bribes on the part of firms from Spain, France, the United States, Japan, and Italy.

The Bribe Payers Index is a subjective indicator, measuring the perception of fellow businessmen, lawyers, accountants, and commercial organizations.

More objective – and disturbing -- has been the revelation of systematic use of what by any common-sense definition would be corrupt payments – albeit clever corrupt payments -- by US, Japanese, and European firms to gain infrastructure concessions in Indonesia in the 1995-2003 period. The scope of the OECD Convention is quite narrow – requiring member states to pass domestic legislation that criminalizes a direct payment to a public official by an international company to secure a contract. The new evidence shows multinational corporations using current-payoff-and-deferred-gift structures to relatives and friends of host country officials in securing power project contracts that do not technically put them at risk of OECD-consistent home country anti-bribery laws, or the US Foreign Corrupt Practices Act.

The basic structure has been for the multinational to approach a prominent family member or close friend of the host country leadership about forming a partnership to own the target investment project (or respond favorably when approached by a family member or close friend about forming a partnership), loan that family member or close friend the funds needed to take an equity stake in the project, and pay a dividend to the family member or close friend more than what was needed to service the original loan. This arrangement functions as a deferred gift – the loan to fund the equity stake of the family member or close friend was paid off via the dividend over time. The excess return above what was needed to service the loan was a current payoff.

Unlike a genuine equity investor, the family-member-or-close-friend partner had no capital of his/her own at risk, nor any responsibility to repay the loan out of his/her own assets. The equity stake came to the family member or close friend for free – the only “service” that was required was to ensure the foreign company was chosen to receive the infrastructure concession (in the Indonesian case discussed later, all but one of twenty-seven internationally-funded power projects were awarded without competitive bids). In some cases, the family-member-or-close-friend partner began to receive “dividends” as soon as the concession was awarded, before the
project was even in operation. Then, since the return to cover the loan payments and the current payoff depended upon the project remaining profitable, the family member or close friend had an on-going interest in ensuring that the project enjoy beneficial treatment.

Particularly startling has been the discovery that some of these sophisticated payment mechanisms – as deployed by US investors to obtain infrastructure concessions – had been vetted by well-respected US law and accounting firms as part of the investors’ due diligence prior to committing funds, and reported to the US Securities and Exchange Commission, without objection.

The following is a schematic illustration of how these arrangements were constructed:
How to Provide Corrupt Payments Without Running Aftoul of the US Foreign Corrupt Practices Act

As a hypothetical example that illustrates what has been uncovered in Indonesia, “MNC Enterprises” is considering investing $200 million in the Bahia power plant (“Bahia Power & Light”) to expand electricity production for the capital city of a developing country.

How can MNC Enterprises ensure that it secures the concession to supply the electricity, and receives favorable treatment on rates and other regulatory issues over the life of the project?

One way might be to deliver an envelope containing $1 million to the daughter of the President of the country each year for twenty years. A second way might be to give the daughter of the President a one-time gift of $20 million. A third way might be to provide a stream of payment’s to the daughter’s Swiss bank account that allows her to accrue at least $20 million before the concession is ended.

If these methods seem too blatant in violating the spirit of the 1999 OECD Convention against bribery, and perhaps even the letter of developed country law against corrupt payments, an alternative approach to securing the concession, and ensuring favorable treatment, might be to take on the President’s daughter (or another family members or cronies) as a local partner.

In this hypothetical example, the daughter of the President of the country is CEO of “Presidential Initiatives, Inc.,” a small highly successful private company providing consulting services in the capital city.

The foreign investment code of the country where Bahia Power & Light is located requires that all power projects have a local partner. MNC Enterprises offers to sell Presidential Initiatives a 25 percent share in the Bahia power plant.

Where does Presidential Initiatives get $50 million to pay for its quarter share of Bahia Power & Light? From its own capital reserves? Most assuredly not.

MNC Enterprises loans Presidential Initiatives the $50 million needed for the joint venture. Presidential Initiatives is certified by Moody’s as a good credit risk, having earned high profits while never having defaulted on any commercial payment, over the preceding decade. MNC Enterprises loans Presidential Initiatives $50 million at the Moody’s-recommended Triple AAA rate of 6%.

The new Bahia Power & Light project has been rated as an untried and potentially risky enterprise by Moody’s. It receives Moody’s BBB rating, requiring repayment terms 3 percentage points (300 basis points) higher than Triple AAA, according to international
standards. MNC Enterprises creates stock shares in Bahia Power & Light that pay a dividend of at least 9% to the joint venture partner as long as the project is profitable.

From the 9% stock payment stream ($4.5 million each year), Presidential Initiatives, Inc., repays the 6% loan ($3 million), plus a small portion of the principal (perhaps $0.5 million), each year, and pockets the difference of $1 million.
The loan principal will essentially never be paid off (full repayment would take one hundred years). The dividend is paid only in years that Bahia Power & Light earns a profit, ensuring that the indigenous partner will use her influence to ensure good treatment for the MNC Enterprise affiliate. The larger the profits, the larger the dividend.

_A hypothetical example by Theodore H. Moran, drawing upon materials presented to the Working Group on Reforming OPIC for the 21st Century and other new evidence from Indonesia, to be published by Louis T. Wells, Jr., Harvard Business School._
Actual partnership arrangements were actually much more blatant – with outsized dividends and miniscule equity costs – than the schema presented above.

The consortium established for the Paiton I power project in Indonesia, for example, consisted of four foreign corporations: Edison Mission Energy, Mitsui, and General Electric Capital Corporation). Their local partner was Batu Hitam Perkasa (BHP) that featured a prominent Indonesian named Hashim Djojohadikusumo, who was the brother-in-law of President Suharto’s second daughter, Titiek.

According to Louis T. Wells, Jr., of the Harvard Business School, Mission, Mitsui, and GE loaned $49.6 million to Batu Hitam Perkasa (BHP) to acquire a 5% interest in Paiton I. It is not clear whether BHP paid “a market rate of interest” or a mere 1.5% per year. In any case, the foreign consortium then paid a dividend to the BHP “partner” high enough that 65% could be “withheld” to service the debt. This was called a “carried interest arrangement”. The Indonesia partner put up no money of its own, had none of its assets at risk, and did not have to service the loan at all if the partner did not receive the dividend from the consortium.

With regard to CalEnergy’s Dieng geothermal project, ten percent of the equity was held by PT Himpurna Enersino Abado (PT HEA), a subsidiary of an association of retired Indonesia military officers. Not only were these friends of President Suharto (a former general), they were also potential competitors or coup-makers, and had to be kept satisfied. There is no evidence that PT HEA possessed any business or consulting skills whatsoever. As in the Paiton I case, PT HEA used a loan provided by CalEnergy to “purchase” the equity stake. What is different is that the foreign investor began to pay its Indonesian “partner” a dividend even before the project had been built.


136 Ibid., ch. 13.
Why were structures such as these not found to be in violation of the US Foreign Corrupt Practices Act (FCPA)?

When Louis Wells posed this question to the Justice Department, the answer was that whether a series of payments, or a loan, or a deferred gift would be a violation of the FCPA would depend upon whether it occurred at the direction of the President, or other public official, and whether some benefit accrued directly to the President, or other public official. In actual cases involving his daughters or friends, there is no record that President Suharto issued such a directive on their behalf, or required them to share her gains with him.

Section V provides additional detailed evidence of how US infrastructure firms used these investor-financed partnership structures with President Suharto’s daughter and other prominent Suharto-associates to secure contracts in Indonesia, after having them reviewed by outside counsel, and reported the details to the Overseas Private Investment Corporation without any objection being raised as to their eligibility for OPIC guarantees.

The evidence that has been brought to light thus far about how the arrangements between foreign investors and relatives or close friends of the leadership in the host country were constructed comes from infrastructure projects. But this method of securing concessions and negotiating favorable investment agreements could equally well apply to other sectors – petroleum and mineral ventures, for example – in other countries.

These discoveries leave no doubt that the OECD effort to thwart the use of corrupt practices will require considerably more determination – and more sophistication – than member countries, including the United States, have shown thus far. If the national legislative practices being examined under the auspices of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions cannot, at the end of the day, show that schemes like these discovered in Indonesia will be detected, found to be illegal, and punished, then the OECD review exercise will have to be considered a sham.

Section V will offer suggestions about how the OECD endeavor can be strengthened, and given new teeth.

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137 E-mail dated 08/06/02 from Philip Urofsky, Special Counsel for International Litigation, Fraud Section, US Department of Justice, reported in Wells, forthcoming.
Ensuring Transparency in the Payment and Disposition of Natural Resource Revenues As Well As Infrastructure Concessions

Greater vigilance in preventing corrupt payments and bribes on the part of international investors can help developing countries secure the most competitive infrastructure projects and most promising natural resource projects on the best terms possible. But – in the case of oil, and gas, and mining investments -- the challenge of using a favorable natural resource endowment to finance domestic development does not end with greater vigilance in preventing corrupt payments and bribes on the part of international investors to secure concessions.

The larger problem lies with the diversion of production output and public revenues into the hands of public officials and other individuals within the host country. One of the most powerful components of the argument that rich oil and mineral deposits constitute a “resource curse” is the ease with which such endowments create a culture of kleptocracy, finance wars and dictatorships, breed a rent-seeking society, and fail to meet the needs of the poorer segments of the population.138

To combat this, various NGOs – led by George Soros – proposed a “Publish What You Pay” solution, requiring that investors in extractive industries be required to make public all taxes and fees paid to host governments before being allowed to list their shares on the US or other major stock exchanges.139

It soon became clear that in this form the “Publish What You Pay” approach suffered from serious faults. Foreign investors had often signed contracts requiring them to keep the terms confidential, as insisted upon by host authorities. Publicly-traded extractive companies feared that they would be placed as a competitive disadvantage to state-owned companies, or to private companies without such disclosure requirements – from Russia, China, India, or Turkey, for example.140

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139 See the Publish What You Pay Campaign at www.globalwitness.org.

To address these shortcomings, the UK government launched the Extractive Industries Transparency Initiative (EITI) at the World Summit on Sustainable Development in Johannesburg, in 2002, an effort to put pressure on host countries to require all investors (equally) within a given host country to publish what they pay while host authorities simultaneously reveal how they dispose of the revenues.\textsuperscript{141} Rejecting the argument that it should refrain from helping finance extractive industry projects altogether, the World Bank Group endorsed the EITI in 2003, created a multi-donor Trust Fund to promote transparency, and began to work with developed and developing country governments to gain support for the initiative and to provide training for government officials and civil society organization that might serve as monitors and auditors.\textsuperscript{142}

The first wave of countries endorsing the EITI, and working on implementation, included Azerbaijan, Ghana, the Kyrgyz Republic, and Nigeria. A second wave included Angola, Chad, the Republic of Congo, Ghana, the Kyrgyz Republic, Peru, Gabon, Sao Tome and Principe, and Timor Leste, with other countries expressing an interest in participating.

The EITI cannot be effective, however, unless the countries that sign on require that all companies – including state-owned companies and privately-held companies from all countries (not leaving out Russia and China) – submit their payment records for independent audit, which can then be matched with expenditure records of host authorities that are also independently audited. This match-up must be conducted by a credible, independent monitor whose findings are made public, highlighting discrepancies that need to be reconciled. The countries that sign on must agree to a common time-bound action plan to implement the EITI. Such action plans can then be backed with resources from the World Bank Trust Fund and other donors, to build the capacity for conducting audits and disclosing the results in a manner that can be widely comprehended and tracked by their citizens.\textsuperscript{143}

In preventing the diversion of natural resources and natural resource revenues away from providing for the broad needs of the host country, some sectors provide more scope for developed country action than others. This has proved to be true for the trade in diamonds, where revenues from rough stones have contributed to upheavals in countries such as Sierra Leone, Angola, and the Democratic Republic of Congo.

\textsuperscript{141} The government of Finland has expressed an interest in a similar initiative to cover investors in the forest and paper industries. The Bribe Payers Index survey suggested that the size of bribes in the forestry sector were tenth highest of all industries, equal to mining.

\textsuperscript{142} Complementary initiatives include the UN Convention Against Corruption; the Global Compact launched by the UN Secretary General in 2000; the G-8 Declaration of Fighting Corruption and Improving Transparency agreed at Evian in 2003; the EU Transparency Obligations Directive adopted in 2004; and the IMF Draft Guide on Resource Revenue Transparency 2004.

\textsuperscript{143} The Statement of Outcomes: EITI London Conference, March 17, 2005.
To control the flow of “conflict diamonds”, Southern African diamond producing states met in Kimberley, South Africa, in 2000 to begin negotiations on an international certification scheme for rough diamonds. In 2002, the Kimberley Process Certification Scheme (KPCS) was launched with provisions for regulating the trade in rough diamonds on the part of countries, regional economic integration organizations, and rough diamond-trading entities.

The KPCS requires all participants to implement internal controls to guard against trading in conflict diamonds, and requires that shipments of rough diamonds be accompanied by a Kimberly Process certificate. The signatories agree to trade only with others who have met the minimum requirements of the certification.

The 43 participants in the Kimberly Process account for approximately 99.8% of the global production of rough diamonds.

For most extractive industries, however, developed countries can only play a supportive role, helping fund surveillance and monitoring capabilities. There is no substitute for host countries themselves to join wholeheartedly in the EITI, to make it work on the ground in their countries.

While the effort to get developing countries to sign on to the EITI has been showing progress on a purely voluntary basis, ultimately multinational and regional financial institutions, and national aid agencies will not want to waste their assistance on countries that refuse to take effective steps to ensure that the revenues from their natural resource sectors flow into programs that support broad national development. At the same time, the Extractive Industry Transparency Initiative (EITI) must be steadily expanded in geographical scope, and broadened to cover infrastructure projects as well as mining and petroleum investments.
Section IV
The Impact of Outward Investment to Developing Countries on the Home Economy: Strengthened Competitiveness, or a “Great Sucking Sound”? 

What is the impact of outward investment to developing countries on the home economy?
Do the contributions to growth and welfare from foreign direct investment in the developing world come at the expense of the economic well-being in the home country?
Does outward investment create a “great sucking sound” that exports jobs rather than products?
1. A Careful Look at the Stay-At-Home Option

To make an accurate appraisal of the impact of outward investment on the home economy, it is necessary to examine the counterfactual with some care: *what would happen in the home economy if the outward investment did not take place, or did not take place as extensively, as actually occurred?*

Does outward investment substitute for production at home, or complement production at home?

That is, would the home country firms engaging in outward investment export more from the home market if they did not set up operations so widely abroad, thereby generating jobs for home country workers? Or would they export less, thereby reducing jobs for home country workers?

The answer to these questions lies in contrasting the home country performance of firms that do engage in outward investment, with firms that do not. And it is essential that the comparison be of “apples with apples”, that is, a comparison of the home country performance of firms with comparable characteristics.

A proper comparison is important because the international business community has often pointed out that the multinational corporations that do most of the outward investment from the home country also do more investment at home, more job-creation at home, more technology-creation at home, more exporting from the home market than average firms do. From this, they have argued that the superior record of MNCs in contributing to the home economy derives from the multinational character of their operations.

But the multinational corporations that do most of the outward investment from the home country are different in many ways from “average” firms: they are larger, more R&D-intensive, more advertising-intensive than the “average”. Their superior contributions to the home economy might derive from these characteristics of the corporations (bigger, more R&D-intensive, more advertising-intensive), and not from the fact that they have set up operations overseas. Perhaps they would contribute even more to workers and communities at home if they did not move abroad so aggressively, or even did not move abroad at all.

To find out – rigorously – what would happen to workers and communities in the home economy if the foreign investment did not take place, or did not take place as extensively, therefore, requires contrasting the behavior of otherwise similar firms that do and do not engage in outward investment.

A pioneer in the development of an appropriate methodology to investigate the counterfactual was Thomas Horst.¹⁴⁴ A review of his early work shows clearly what researchers have consistently found since.

As can be seen in the following table, Horst separated his sample of US firms according to those characteristics that might be expected to influence their level of exports. He then compared the export levels of those that essentially remained at home (column 1) with those that had set up some overseas operations (column 2), those that enlarged their overseas operations considerably (column 3), and those that were farthest ahead in globalizing their operations (column 4).

Export Performance of Particular Types of Industries by Foreign Investment Levels (Exports as a Percentage of Domestic Shipments)

<table>
<thead>
<tr>
<th></th>
<th>I: Least Amount or No Foreign Investment (%)</th>
<th>II: Low Middle Range of Foreign Investment (%)</th>
<th>III: High Middle Range of Foreign Investment (%)</th>
<th>IV: Most Foreign Investment (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Tech</td>
<td>2.3%</td>
<td>7.8%</td>
<td>9.7%</td>
<td>7.6%</td>
</tr>
<tr>
<td>Low tech</td>
<td>1.3</td>
<td>3.0</td>
<td>2.5</td>
<td>3.5</td>
</tr>
<tr>
<td>High Advertising</td>
<td>1.0</td>
<td>2.8</td>
<td>2.4</td>
<td>4.6</td>
</tr>
<tr>
<td>Low Advertising</td>
<td>1.4</td>
<td>4.8</td>
<td>7.5</td>
<td>7.7</td>
</tr>
<tr>
<td>High Unionization</td>
<td>1.9</td>
<td>5.5</td>
<td>4.4</td>
<td>3.8</td>
</tr>
<tr>
<td>Low Unionization</td>
<td>1.3</td>
<td>3.2</td>
<td>7.0</td>
<td>7.8</td>
</tr>
</tbody>
</table>

This set of carefully constructed comparisons demonstrates that outward investment pulls exports out from the parent firm that undertakes the investment: the contrast between the percentage of domestic shipments that enter foreign markets for firms in column 1 (the stay-at-home firms) and the percentage of domestic shipments that enter foreign markets for firms in columns 2-3-4 reveals increasing levels of foreign direct investment leading export levels generally upward. This “pull” takes place as home country firms establish distribution networks abroad, transfer intermediate products for assembly abroad, and ship larger amounts of final products abroad.

These comparisons also provide a clear view of the counterfactual – what would the situation be like in the home country economy if the home country firms had not invested abroad. The contrast of “likes with likes”, varying only the level of outward investment, means that firms in columns 2-3-4 would exhibit performance like the firms in column 1 (the stay-at-home firms) if they too stayed at home.

The stay-at-home scenario does not result in higher exports, or larger numbers of export-related jobs – quite the reverse – rising levels of outward investment lead to rising levels of exports and export-related jobs. If firms were prevented from moving abroad – or if obstacles and disincentives were put in the way of their moving abroad – the home economy would be weaker and the jobs available to workers would be fewer and less well-paying.

This positive relationship between outward investment and exports holds for low tech industries just as for high tech industries, for heavily unionized industries just as for non-unionized industries. That is, outward investment creates more export-related jobs at home for low tech workers, and for unionized workers, the same as it does for home country workers in general.
2. The Impact of Outward Investment on Competitiveness and Exports


The strength of the complementarity between outward investment and enhanced-exports is large enough, in fact, to more than offset exports from the investors’ foreign affiliates to third countries that might replace shipments from the home country.

From the point of view of home country strategy, moreover, outward investment strengthens the competitive position of the parent firm vis-à-vis international companies of other nationalities in the recipient country, reinforcing the link between home and host markets. That is, the presence of an offshore subsidiary enlarges the market share of the parent company in the host economy in relation to firms from other home countries; and, conversely, the absence of offshore subsidiaries reduces the market share of the parent in relation to firms from other home countries. A home country policy of discouraging outward investment would leave third markets more dominated by international investors and exporters based in other countries, with less presence on the part of firms from that home country.

Thus, in contrast to the popular notion of a “great sucking sound”, made famous by Ross Perot -- or “Benedict Arnold CEO’s” that “export jobs rather than products”, a campaign slogan of Senator John Kerry in the 2004 presidential campaign, --outward investment from the United States in the aggregate actually enhances the export performance of the home-based firms that make the investment. This has importance for workers and communities where the multinational investors are based that extends beyond the sheer number of jobs in the area.

Since export-related jobs in the United States – like other home countries -- pay wages 9%-23% higher than non-export related jobs, and offer 11%-40% higher benefits, outward investment improves the proportion of good jobs (relatively high wages and benefits) versus bad jobs (relatively lower wages and benefits) in the US labor market.\footnote{Howard Lewis, III, and J. David Richardson, *Why Globalization Matters Most!*, (Washington, D.C.: Institute for International Economics, October, 2001.)}

\footnote{145}
But the benefits that accrue to firms based in the US that have cross-border equity linkages do not come simply from their superior export performance. US firms that invest abroad use frontier production processes in their home country plants more frequently, have higher levels of worker productivity, and enjoy more rapid growth rates of overall productivity than US firms that do not. This leads to a more stable job base. US firms that invest abroad enjoy lower levels of bankruptcy, and are less likely to suffer job loss than counterpart firms that do not engage in outward investment. Overall, firms that engage in outward investment pay their blue-collar production workers 7 to 15 percent more than comparable firms that do not engage in outward investment (7 percent more in large US MNC-owned plants, 15 percent more in small US MNC-owned plants).

Those communities in the home country that serve as a base for US firms that invest abroad enjoy a higher level of economic well-being (even after controlling for size of city and geographical location) than communities that are less globally-engaged. Some of this superior economic well-being can be traced directly to the higher paid workers and managers in the multinational companies. The Eastman Kodak Corporation, for example, has had a strongly positive impact on the economic health of Rochester and Denver, which have achieved the status of 30th and 67th export cities in the United States, respectively, due in part to Kodak’s presence.

But the social value of the export-and-investment-related activities is larger than the benefits that can be captured by the international firms like Kodak in these cities. There is evidence of spillovers and externalities to nearby firms and workers, and to the entire region clustered around the firms undertaking the outward investment.

The rigorous answer to the question -- what would happen in the home economy if the outward investment did not take place, or did not take place as extensively, as actually transpired? -- is that the home economy would be less vibrant, the industrial base of companies would be less competitive, and the number and distribution of high-productivity jobs paying favorable wages and benefits would be smaller.

Once again it is important to pose the counterfactual question properly: would the home economy be better off or worse off if the outward investment did not occur, or did not proceed as vigorously, as happened in reality. The appropriate counterfactual is not, would outward investment lead to zero employment shifts or losses? Nor even, would outward investment lead to a net positive number in aggregate employment?


The evidence indicates that a large proportion of outward investment is “defensive” in nature, that the outward investment moves operations offshore when the parent firm expects those operations to become non-viable at home over the next five-year period. It is possible therefore in some instances that the home economy would benefit more over time with the outward investment taking place than not taking place, even if the immediate net job impact were to be negative, but not as negative as it would be if the parent firm failed to build up distribution networks and assembly facilities abroad.

In the aggregate, however, the contribution of US firms engaging in outward investment to the US home economy has been strongly positive. Between 1991 and 2001, US MNCs increased the number of American employees from 18.0 million to 23.5 million, a gain of 5.5 million workers, while increasing the number of their foreign employees from 6.9 million to 9.8 million, a gain of 2.9 million workers. Over the course of this period, the US parents expanded their share of total employment within the United States by 1.2 percent, from 16.6 percent to 17.8 percent.

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3. Outward Investment and Job Expansion or Job Loss in Particular Industries

Outward investment could be taking place in a sector that was expanding on a net basis in the home country, in a sector that was trying to hold its own in the home country (with internal changes in the job mix), or in a sector that was declining on a net basis while reconstituting itself around a smaller but more productive set of activities. It is not plausible to imagine that all the adjustments to the process of globalization in these diverse sectors would take place without some reshuffling of workers -- layoffs, job upgrades, job reclassifications, new hires. The anxiety about this process among workers is magnified by the fact that movements of downsizing and upgrading often take place simultaneously in a given industry, but at different plants, with the plants that are closing creating a much more dramatic image than the plants that are hiring.

The only clear conclusion from the data is that the home economy, firms, workers, and communities would be better off overall -- *ceteris paribus* -- if outward investment were supported, and worse off if outward investment were not supported.

These aggregate statistical relationships are supported by case study data from industries across the spectrum of skill-levels.

The ability of high technology firms in the United States – such as Intel, Seagate, and Hewlett Packard – to maintain themselves as leading system-integrating manufacturers of complete product lines, rather than becoming software engineering consulting firms, has depended upon the amalgamation of design-and-test functions for product development in the home country with offshore assembly. The livelihood of tens of thousands of much above-average-compensation jobs in California, Colorado, Massachusetts, Minnesota, New York, Oregon, Pennsylvania, and Texas is supported by hundreds of thousands of production-line jobs in Singapore, Thailand, Malaysia, China, Costa Rica, and Mexico. The idea that these companies could have maintained themselves – and the United States – on the frontier of these high tech industries without constructing closely integrated supply networks in the developing world is fanciful.

The same is no less true of mature industrial companies – including mature industrial companies in sectors where high rates of unionization have been prevalent – that have been struggling to consolidate their position in the United States. The US auto companies slowed the loss of market share to Japanese and European imports in the 1980s and 1990s in part by relying on cost and quality advantages that came from the sourcing of parts and components offshore. General Motors in particular used Brazil as

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a test ground for production processes and management techniques that the parent reintroduced into the United States to reinforce major GM divisions in the home country. Ford has done the same in Mexico. Complaints to the contrary notwithstanding, the data show clearly that the relatively high-wage, high-benefit jobs of unionized autoworkers in the United States have been supported by the outsourcing strategies of the parent firms.
The relevant comparison to assess what produces the most beneficial impact on the home economy is not whether aggregate employment in the US auto industry has expanded or shrunk between 1975 and 2005, nor whether a given plant in Mexico or Brazil has taken over functions previously assigned to a plant in Michigan (a “runaway plant”), but what would have happened to the parent firms, workers, and communities if the companies had been less vigorous in their international investment strategies.

In 2004-5, Ford launched a new version of the company’s best-selling F150 truck. Ford’s Essex Engine Plant in Windsor Canada is the exclusive source of the 5.4-liter, 3-valve high performance Triton V-8 engine for the F150. Ford’s contract manufacturer IMMSA of Monterrey is the sole supplier of the M450 chassis for the F150, using inexpensive but reliable Mexican steel alloy.

The success of Ford in holding its share of the truck market vis-à-vis the Toyota Tacoma, the Isuzu DMax, and the Daimler-Chrysler Dodge Ram will depend upon the company’s high performance NAFTA-integrated supply chain.

Despite the UAW’s apoplectic opposition to NAFTA, the fate of UAW workers at Ford’s US assembly facilities depends directly upon this trade-and-investment agreement. “Withdrawing from NAFTA”, as advertised in some political campaign slogans, would leave UAW workers looking for new jobs, almost certainly paying lower wages and offering lesser benefits.
Perhaps even more surprisingly, the viability of industries where low-skilled, labor-intensive operations is the norm has depended upon mastering international supply chains through foreign direct investment as well as subcontracting. Howard Lewis and David Richardson provide a detailed look, for example, at the globalization of the Schwab garment company, responsible for the Ralph Lauren line of children’s clothes, with plants in Cumberland, Maryland, and Martinsburg, West Virginia.\footnote{Howard Lewis, III. and J. David Richardson, \textit{Why Globalization Matters Most} (Washington, D.C.: Institute for International Economics, October, 2001.), “Old local economy meets new global economy in Western Maryland”, pp. 9-11.}

It may be worthwhile to spend a moment looking at this case study from the apparel industry. Over the course of the 1990s, the total number of jobs remained constant, but the types of jobs changed. Sewing jobs and cutting jobs moved offshore, replaced by marketing, distribution, and business-service jobs.

Lewis and Richardson trace the family of one worker -- “Pam’s family” -- through five generations. The great-grandmother, grandmother, and mother worked as sewers in Cumberland for the minimum wage. The worker under scrutiny -- Pam -- moved from sewing to customer service via computer courses at a local community college. As of 2001, she supervised 5 managers and 18 contract managers to ensure that products with correct bar codes, correct labels, and prices arrive at correct destinations on time. Pam’s son managed distribution in the Martinsburg center. Both Pam and her son enjoyed wages and benefits, as well as profit sharing, that placed them more firmly in the middle class than the grandmother and great-grandmother could ever have hoped to be.

In one respect this case study might appear quite unusual – a success story of adjustment, survival, and prosperity in the midst of a shrinking industry. After all, from 1996-2002, there were 1,890 extended mass layoffs or permanent worksite closures in the textile and apparel industry, leading to 328,000 worker separations.\footnote{Mike Horrigan, Bureau of Labor Statistics, “What the data tell us about trends in the US textile industry: mass layoff survey”, \textit{Colloquium on the Effects of International Trade on a Community: A Case Study – Meeting Summary} (Washington, DC: National Academies of Sciences, Committee on Monitoring International Labor Standards, January 7, 2004). In textiles (not apparel), the largest cause of employment decline comes from increased productivity at home, not imports.} Of these, 315 extended mass layoffs or permanent worksite closures and 55,000 worker separations were due to import competition, and 98 extended mass layoffs or permanent worksite closures and 17,000 worker separations were due to overseas relocation of the plant.

Yet the Schwab garment company reconstituted itself with plants and subcontractor networks offshore, while replacing lower-skilled production jobs with higher-skilled managerial tasks, thereby maintaining the same aggregate number of jobs at its sites in Maryland and West Virginia constant. The more general pattern, in contrast – at least in the textile and apparel industry – has been simply to hang on to the production jobs as long as possible with catastrophic results when such a strategy fails.
But in another respect, this case study is surprisingly typical. Companies that meet the challenge of globalization by integrating themselves via trade and investment into the international economy – even in declining industries – are the ones that survive and prosper.¹⁵⁴

The array of outcomes that can result from outward investment – from strengthening the parent firm’s competitive position and improving the proportion of “good jobs” in the home economy, to imposing the burden of adjustment on firms, workers and communities least capable of coping – can be seen in the home-country histories of the sectors where new investment was helping Mexico and Pakistan upgrade in reaction to competition from China (see the box -- Contrasting Experiences with Instability and Adjustment: Pakistan and Mexico -- in Section I of this volume).

Every case of outward investment tells an idiosyncratic tale. The common theme, however, is that companies that try to utilize the optimal mix of high productivity/high wage and lower productivity/lower wage operations across borders fare better than companies that do not, that better-trained workers with transferable skills fare better than lesser-trained workers without transferable skills, and that the attempt to maintain the status quo in the face of changing competitive conditions in world markets is simply not an option that benefits either firms or workers. Firms and workers that cannot adjust to the pressures of competition from abroad bear the brunt of the costs of dislocation, and – at present – do not have much in the way of support mechanisms to cushion the impact.

Part I of this volume showed how Mexico and Pakistan attempted to cope with having some foreign investors shift operations from their own economies to China, and elsewhere. To accomplish this, Mexican or Pakistani authorities tried to attract new investors to take advantage of higher-skilled workers able to carry out more sophisticated tasks with superior quality-control than was available at plants in China. In three cases, they succeeded by attracting new investors from the United States.

This BOX tells three stories of what happened to those workers left at plants in the United States, as international investors moved operations to Mexico or Pakistan.

The first two stories have a happy ending. The third does not.

US Results from Toyota’s shift of truck-bed production to Mexico

Toyota’s decision to move truck-bed production for the Tacoma from the United States to Mexico in 2002 did not result in any layoffs in US operations.” Instead, Toyota undertook an internal redeployment of labor at a plant employing more than 540 workers in Long Beach, California, to producing catalytic converters, steering columns, and other parts.

As Toyota’s Tijuana plant was subsequently expanded to full assembly of the small-sized Tacoma – completed in 2004 – Toyota revamped the Long Beach plant to begin production of medium-duty Hino panel trucks with an injection of several hundred

million dollars.\textsuperscript{156} This represented the new first vehicle production plant in Southern California since 1992.

Toyota’s goal, of which both the Mexican and the US plants were an integral part, was to join the world’s top five truck-makers within three years. In 2003-4, Toyota added some 12,000 workers (net) to its US employment base.

\textit{US Results from Pratt & Whitney’s shift of machining operations to Mexico}

Although the details of internal workplace adjustments within Pratt & Whitney -- following the corporation’s decision in 2002 to open a plant (initially employing 40 workers) across the Mexican border -- are not available, it is plausible to speculate that some workers previously performing engine work-overs and repair services for Aeromexico in Texas might have been downsized or laid off.

Within a year, however, after having earned licenses of certification from both the US Federal Aviation Administration and DGAC (the government aviation agency of Mexico), Pratt & Whitney’s Mexican affiliate managed to expand the P&W relationship with Aeromexico in 2003 to include a long-term service agreement for the airline’s entire 757 fleet.\textsuperscript{157}

This set the stage for the plant in Mexico to become the conduit via which Pratt & Whitney Aftermarket Services (USA) could offer overhaul and fleet management programs more broadly in Latin America. The net result of this realignment of operations was that the competitive position of Pratt & Whitney Aftermarket Services (USA) – and the Pratt & Whitney corporate system as a whole – was strengthened, with favorable results for P&W workers at all levels.

\textit{US Results from the Upgrading of Textile Production in Pakistan}

At the same time Pakistan realigned its textile industry from spinning rough cloth to finishing “home textiles” (pillows, sheets, comforters), the Pillowtex Corporation of North Carolina tried to maintain basic production operations as long as possible, laying workers off and then bringing them back to the mills, rather than repositioning itself as an international distribution coordinator. Pillowtex was the successor to Cannon Mills, had twice declared bankruptcy, and was being run by its banks and other creditors.\textsuperscript{158}


The 4800 workers at Pillowtex “received good medical, retirement, and vacation benefits, and made a decent living.” Hourly workers earned an average of $22,000 plus benefits; for salaried workers, the average was $55,000 plus benefits. On July 30, 2003, in the midst of a major US economic downturn, Pillowtex suddenly announced the closing of all of its plants in Kannapolis, North Carolina.

This experience is not at all like the case study of the Schwab garment company in Maryland and West Virginia – “Pam’s family” – where the company had over time reorganized its strategy to combine overseas operations with home country support and marketing services, with local workers upgrading their skills to cope with the challenges of globalization.

Instead Pillowtex simply sat still and hoped that its operations would survive intact. The failure of this strategy and the closing of its plants had a devastating impact on the workers, and on the community.

The Pillowtex workforce had an average age of 47, with 1300 individuals over age 55. Most were long-term employees without a high school degree (many less than 8th grade). One-quarter were single parent families. Five hundred did not speak English.

Nearby options for reemployment were few, even if the US economy had not then been in recession. A survey of the immediate area (Cabarrus and Rowan Counties) showed local schools, government offices, telephone company, and medical centers as the largest employers, along with Phillip Morris, Fieldcrest Cannon, and Wal-Mart Stores. The most rapidly growing industry in the region – an hour commute to Charlotte – was biotechnology, for which virtually none of the workers were trained or suited.

Because the Pillowtex employees lost their jobs as part of a bankruptcy rather than being laid off by a functioning company, they were not eligible to receive COBRA healthcare continuation coverage. The only available health care insurance, from Blue Cross/Blue Shield, rated workers who applied as individuals, not as a pooled community (as COBRA coverage would have done). This left those employees with preexisting health problems facing huge premiums ($5000 per month for a middle-aged individual with diabetes).

A new federal tax credit (HCTC) program to cover health insurance assisted only those who were part of families earning income and paying federal taxes, which excluded many of the Pillowtex workers. Surveys of worker concerns showed that a predominant worry was how to continue paying the mortgage on their house, so as to avoid becoming homeless.

As the US economy climbed out of recession, the redeployment of Pillowtex workers came slowly. Not until the second half of 2004 did the level of unemployment around the Pillowtex plant approach the average for the state of North Carolina.

159 Harris Raynor, UNITE, Colloquium on the Effects of International Trade on a Community: A Case Study – Meeting Summary, op. cit., p. 5.

160 Centralia Workforce Development Board Newsletter, August, 2005.
The concentrated impact of the negative effects of globalization in the Pillotex case is reflected in nation-wide studies of job displacement.

Detailed analysis of the fate of displaced workers in industries where trade-and-investment pressures are strong indicates that one quarter report earnings losses of 30 percent or more when they move to new jobs after being laid off. These severe losses are concentrated among workers who are older, less skilled, and/or relatively inflexible in being able to move to a new job location.

As in the developing world, the appropriate way to address the challenges of globalization is not to try to preserve workers in increasingly uncompetitive occupations, but to prepare them to take advantage of new opportunities, and to cushion the impact -- in some cases, as indicated above, the crushing impact -- on those who cannot do so.

END BOX

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4. Upgrading and Adjustment: the Home Country Agenda

The globalization of trade and investment allows both developed and developing countries to specialize in those goods and services that they produce most efficiently relative to others. This is the principle of comparative advantage. The spread of trade and investment across borders also brings dynamic benefits, from broader adoption of cutting-edge technology and management techniques, resulting in increased competition and pressure for innovation. Rising flows of imports and exports give consumers access to new and cheaper products, and give firms new and cheaper inputs. This enables firms to become more productive, and hire more workers. It enables workers to become more productive, and earn higher wages and receive higher benefits.

The globalization of trade and investment since the end of the Second World War has raised the standard of living by approximately $1 trillion per year.¹⁶² The gains from future liberalization of trade and investment range from $450 billion to $1.3 trillion annually.

The gains from the globalization of trade and investment outweigh the costs by a large factor. The ratio of benefits to costs, for the United States, is not close.¹⁶³ Not 2 to 1. Not 10 to 1. But 20 to 1!.

These gains accrue disproportionately to firms and workers that take part in the phenomenon of globalization – whose operations involve exports and imports, whose owners engage in inward and outward foreign direct investment, whose plants are part of multinational operations. “Global engagement”, in David Richardson’s terminology, is like a fitness center, raising productivity, raising wages, and raising benefits.¹⁶⁴

The “fitness payoffs” are spread across small firms as well as large firms, low-tech as well as high-tech activities, unionized workers as well as non-unionized, minorities and women as well as white males, even small towns as well as large. Insularity – the opposite of global engagement – is the source of the unevenness of the distribution of gains. Firms and workers whose activities partake of trade and international investment gain more opportunity from globalization; firms and workers whose activities do not get


¹⁶³ Ibid.

less. The superior benefits to workers, managers, owners, and communities persist in bad times as well as good.

The globalization of trade and investment speeds up the pace of change, for better and for worse. The United States has the highest rates of job creation and job destruction of all developed economies, creating an underlying 15 million jobs each year, while destroying 13 million – apart from cyclical fluctuations. Close to one in five working-age people can be expected to lose and/or gain a job in any given twelve-month period.

As in other countries, this process of “creative destruction” – in Joseph Schumpeter’s famous characterization – comes primarily from the forces of domestic competition, technological change, and productivity improvements (requiring fewer workers to produce the same level of output). But the globalization of trade and investment reinforces the indigenous dynamics of change.

As introduced in Section I, the tools for taking advantage of the forces of globalization, and buffering the costs, are not dissimilar for developing and developed countries.

In an ideal world, these tools include more effective primary and secondary education, including school-to-work programs in which business representatives participate in continuous design and redesign of the curriculum.

They include widely available vocational training opportunities with nation-wide certification, backed by easily accessible educational loans or vouchers for transitioning workers, and use-it-or-lose it training tax credits for businesses to use for current employees.

They include one-stop-shop adjustment assistance centers, to help with job search skills, maintain job banks, and advise on training options.

They include wage insurance or unemployment insurance programs, with hassle-free certification, that encourage re-training and re-employment rather than immobility.

They include rapid-disbursing health care tax credits or subsidies while workers are retraining and searching for new jobs.

They include social safety nets for those unable to improve their skills or adapt to changing circumstances.


These tools for taking advantage of the forces of globalization, and buffering the costs, require adequate funding -- at the national and local level -- that does not contract disproportionately during periods of strained economic circumstances.

5. Is the Outsourcing or Off-Shoring of Services “Different”?

The discussion about the outsourcing or off-shoring of services usually refers to the movement of jobs related to information technology, computer trouble-shooting and technical services, financial services, medical record keeping and evaluation, and call-centers to sites outside the home country. Sometimes this takes place via foreign direct investment from the home country that sets up the offshore service center; more often, the home country company merely contracts out for services from abroad that had previously been supplied within the home market.

To what extent is this a new challenge, a novel threat to relatively high-skilled workers in the home country?

A review of many of the processes involved in the globalization of industry, as examined previously in this volume, suggests that this is a much more familiar phenomenon than is commonly assumed.

When Volkswagen gained market share at the expense of Ford in the early 1980s, this represented competition between Volkswagen’s German engineers-and-managers and Ford’s US engineers-and-managers, as well as between the workers at the two companies. Ford layoffs and downsizing in the 1980s included engineers and managers, as well as production workers.

When Volkswagen competes with Ford in 2005, this represents competition between Volkswagen’s German-and-Brazilian engineers-and-managers and Ford’s US-and-Mexican engineers-and-managers, as well as between the workers of the two companies. Layoffs at either company would include engineers and managers, as well as production workers.

The globalization of manufacturing and assembly surveyed in Section I also generated many of the same feed-back loops that can be expected from the globalization of service jobs today. The integration of computer, telecom, and semiconductor plants in Asia and Latin America into MNC global sourcing networks – with rising levels of backward linkages via contract manufacturing in developing countries – led to final product price declines of 10-30 percent from 1995 to 2002, according to Catherine Mann, generating an extra $230 billion in US GDP and an extra 0.3 percent in productivity growth, with
associated job increases that helped reduce US unemployment to a historically low 3.9 percent.\textsuperscript{167}

Turning from the globalization of information technology (IT) hardware to the globalization of IT software and services, the results are proving to be similar. The spread of IT software and services to India and elsewhere is now producing a second-wave of IT price reductions, allowing IT to expand more broadly throughout the US economy as smaller businesses and new sectors (health services, retail trade, construction) find that they can afford customized applications.\textsuperscript{168} Once again, the aggregate impact on economic growth, productivity, and job creation in the US economy is decidedly favorable in comparison to an imaginary world in which IT goods and services were not being globalized.

The overall benefits from the globalization of goods and services, however, can not mask the anguish of individual data-entry workers or computer programmers – or medical record keepers, or call center operators – who lose their particular jobs in this process of outsourcing and off-shoring. As in the case of textile and garment workers, the policy need is for programs that help them improve their skills to move upwards in their given careers, or to train for new jobs, while cushioning the burden of dislocation when layoffs occur.


Section V

Improving Developed Country Efforts to Support Developing Country Growth via Foreign Direct Investment

What kinds of measures can developed countries take to facilitate the flow of foreign direct investment to developing countries, and ensure that the projects involved support (and do not detract from) host country growth and welfare?

How does the United States rate according to criteria designed to measure developed country performance?
1. Developed Country Measures to Help Developing Countries Benefit from FDI

Providing an answer to the question of how developing countries can facilitate the flow of foreign direct investment to developing countries, and ensure that the projects involved support (and do not detract from) host country growth and welfare, involves a certain amount of conjecture.

Surveys of what international investors say they want in order to engage in FDI compile long wish-lists of subsidies and special favors that might or might not be decisive in influencing any given investment decision, and might or might not be desirable to help host country development.

Measurements of “additionality” – the amount of “extra” FDI generated by a given developed country policy tool, the reduction in FDI that would take place “but for” a given developed country action – have been notoriously difficult to construct.

Developed country policy measures that are strongly advocated by the multinational investment community sometimes – as reported later – show no statistical correlation whatsoever with the actual outcomes of international investment flows.

Despite the uncertainties about which developed country instruments affect outward flows of international investment to developing countries by how much, the preceding Sections point to three areas in which developed countries policies are clearly important. These are 1) provision of national or multilateral political risk insurance; 2) avoidance of double taxation of profits earned abroad; and 3) regulation to combat bribery and to prevent diversion of public revenues to private pockets.

At the same time, some developed country policy actions clearly hinder outward FDI flows. As noted in Section I, for example, national, state, and municipal authorities in the developed world often offer substantial packages of locational incentives to attract multinational investors to their own economies, or to keep them from leaving. As reported there, the potency of these locational incentives in dampening and discouraging outflows of FDI to developing countries has been growing over time.

Finally, there is a significant interaction between trade liberalization and the facilitation of foreign direct investment that extends beyond the scope of this volume. Multilateral trade liberalization, and bilateral or regional trade agreements, have as a byproduct the stimulation of foreign direct investment flows among the participants. Conversely, developed country protection against imports and subsidies for local production (such as agricultural support programs) undermine the ability of international investors to use poor host economies as platforms for export. Antidumping regulations that are filed for reasons other than international price discrimination have the protectionist effect of deterring foreign investment – developing countries with a comparative advantage in industries that range from processed seafood and fruit juices, to manufactured products,
to chemicals and petrochemicals, find exporters, including foreign-owned exporters, penalized and discouraged from expanding investment.

*The Rationale for Public Support: Market Failures and Externalities*

What does it mean for developed countries to “facilitate”, “support”, or “promote” flows of foreign direct investment to the developing world?

On the one hand, it could mean that developed countries simply remove barriers in the way of outward FDI flows to developing countries, but do not take special measures to encourage such flows.

On the other hand, it could mean that developed countries design policies that explicitly discriminate in favor of outward investment to developing countries – tilting the playing field, so to speak, to reward outward FDI to the developing world more generously than other kinds of investment.

In between, it could mean that developed countries devise mechanisms to correct for market failures that hinder flows of foreign direct investment to developing countries, when such flows generate externalities for the capital-importing and capital-exporting countries involved.

The analysis presented in Sections I through IV points toward the first and the last approaches to public support – removal of barriers to investment flows, along with light-handed measures to overcome market failures and allow enjoyment of positive externalities.

Sections I and II pointed out that appropriately structured FDI projects in manufacturing and assembly can make a strongly positive contribution to host country development, adding to the capital base, improving efficiency in use of local resources, and altering the production frontier of the host economy.

Vital to the discussion here, however, Sections I and II noted that FDI in manufacturing and assembly can also generate positive externalities – economic and social benefits for the host country beyond what can be appropriated by the investors themselves. Foreign investment projects not only utilize host country resources more productively and make a larger contribution to host country growth than domestic investment, but they also train workers and managers who leave the foreign firm and move throughout the host economy, and transfer technology, management techniques, and quality control procedures to other firms in the host country (in particular, in a vertical direction to suppliers, but also sometimes in a horizontal direction to rivals).

Section III showed that FDI in natural resources and infrastructure can also make a substantial contribution to host country development. Petroleum and mining industries generate resource rents a large portion of which can be taxed away by public authorities – if corruption and diversion are prevented – for broad public use. Well-functioning
infrastructure allows local businesses to operate more competitively, expanding employment and generating more rapid economic growth.

Section IV noted that outward investment from developed countries – conventional wisdom notwithstanding – actually enhances the export performance of home-based firms that make the investment, improves the proportion of high wage-high benefit jobs in the home economy, and reinforces the stability of earnings in communities where globally-engaged firms are located.

Vital to the discussion here, once again, is the discovery of positive externalities – that the social value of the global trade-and-investment-related activities to the home economy is larger than the benefits that can be captured by the firms that undertake the outward investment.

Thus, not only can FDI from developed to developing countries enhance welfare, growth, and the creation of good jobs in both capital-exporting and the capital-importing states, but also generate positive externalities for both sides in the process.

The preceding analysis showed that these beneficial results and positive externalities do not, however, emerge from every FDI project. Some FDI projects detract from welfare. Some FDI revenues are diverted to corrupt officials.

Thus, within the mechanisms to facilitate FDI flows to developing countries, there is a rationale for developed countries to separate out those investment projects that do provide positive benefits to both sides, from those that do not, and to support the former but not the latter – or, to take measures to turn the latter into the former.

** Provision of Publicly-Backed Political Risk Insurance **

The inability to make credible commitments about the treatment of foreign investors that endure from one minister to the next, or from one government administration to the next, constitutes a market failure for many developing countries. As Section III noted, breach of contract occurs most frequently in natural resource and infrastructure projects, but is present in other sectors as well.

“Pioneer projects” and “first movers” are particularly prone to the dynamics of the “obsolescing bargain”, but later investors are subject to the same process of forced contract-renegotiation as well, especially if they involve large fixed investments and long payback periods: precisely the kinds of projects, paradoxically (and perversely), that are likely to generate substantial externalities for the host economy.

Private political risk insurers – such as Lloyds of London, Zurich, or AIG -- can play only a limited role in dealing with breach of contract. They offer compensation if host countries take political actions that damage the project covered. The existence of private insurance policies is often kept secret, so that host authorities do not single out well-
covered projects for harsh treatment (knowing that the investor will not actually suffer large losses).

Quasi-official political risk insurance, such as that provided by multilateral lending agencies like the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, or by regional development banks such as the Inter-American Development Bank, or by national agencies such as the Overseas Private Investment Corporation (OPIC) of the United States, also offer compensation.

But their “extra” facilitative support for investors comes in the form of what Section III characterized as deterrence against hostile actions on the part of the host authorities.

As a consequence, official political risk insurance – from a national or multilateral provider – can help provide credibility to host country promises about treatment of foreign investment projects, especially politically sensitive projects. The presence of multilateral or national political risk insurers in a project aids in overcoming the market failure associated with imperfect contracts by helping host authorities to “bind the hands” of themselves and their successors, to limit opportunistic behavior.

Official political risk insurers – especially MIGA, or the counterpart in a regional multilateral development bank like the Inter-American Development Bank, Asian Development Bank, or the European Bank for Reconstruction and Development – can also sometimes help mediate potential disputes behind the scenes before they become actual claims.

The involvement of national or multilateral insurers thus provides comfort to foreign investors as they contemplate a risky project. But the rationale for official “support” does not extend to a subsidized rate for the insurance. It would be inappropriate for a multilateral guarantee agency such as MIGA, or a national political risk insurer such as OPIC, to use the ability to borrow with the full faith and credit of the World Bank or the US Treasury to under-price insurance from private suppliers or drive them out of business.

Investigating and comparing rates of official and private-sector political risk insurers is not easy. Private insurers do not make the rates they actually charge clients public. Private insurers sometimes provide global policies across bundles of countries and sectors, and give a portfolio discount. Private insurers often offer multiple kinds of insurance, adding property or casualty coverage to political risk insurance, and perhaps other business services as well.

A study using confidential internal data, commissioned by the Overseas Private Investment Corporation from a prominent Lloyds broker, compared OPIC’s insurance rates with comparable private sector coverage, and found that in many cases OPIC’s premiums were actually higher than private premiums, notwithstanding OPIC’s ability to
raise capital with the backing of the US government.\footnote{Berry, Palmer & Lyle. 1998. *A Study of the Political Risk Insurance Premium Structure of the Overseas Private Investment Corporation*. London: Berry, Palmer & Lyle.} In general, OPIC rates appeared to be lower than those of the private sector in high-risk markets and higher in low-risk markets (in part due to less vigorous competition among private insurers in the former and more vigorous competition in the latter).

One method to maintain the deterrent benefit from official coverage while avoiding inappropriate pricing on the part of official insurers might be found in structures like MIGA’s Cooperative Underwriting Program (CUP). The CUP arrangement essentially allows MIGA to take the lead in syndication, with the participants receiving a common insurance rate that they all agree upon. MIGA acts as the insurer of record, and takes the lead in pursuing recovery in the event of a loss, providing the “halo” of deterrence for all participants.

Facilitating outward FDI to developing countries therefore requires policies that allow firms in the home country to participate in the political risk insurance of multilateral lending institutions. Japanese investors, for example, can take advantage of the services of MIGA since the Japan is a member of MIGA. The contrary case might be New Zealand, since New Zealand investors cannot -- New Zealand is not a member of MIGA. In ranking the performance of developed countries in facilitating FDI flows to the developing world, Japan would receive credit in this category; New Zealand would not.

The analysis of Sections I and II showed, however, that it is important that official political risk insurers not provide coverage indiscriminately, without evaluating the positive or negative consequences of the investment. The evidence examined there indicated that FDI in manufacturing and assembly subtracted from host country output when it involved projects oriented toward small, protected local markets.

Here many developed countries would receive a poor grade. A survey of 19 developed countries with political risk guarantee agencies, in 2005, showed that 18 (including those in the United Kingdom, Canada, France, Germany, Italy, and Japan) do not screen projects to disqualify those that depend upon protection to survive.\footnote{Foreign Policy/Center for Global Development Commitment to Development Index 2005.} (For the performance of OPIC in the United States on this issue, see Chapter 3 in this Section.)

More damaging, the community of developed countries has failed to exert pressure upon multilateral guarantee agencies where they have a strong voice -- such as the International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, or the Inter-American Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development -- to initiate such a screening process within these institutions.
Multilateral or national political risk insurers behave in a counterproductive manner when they spread the umbrella of their support over projects that harm host country growth. To avoid this, they need a vetting process that identifies and refuses support for FDI undertaken behind trade barriers to substitute for imports. In this context, the use of project profitability as the sole criterion for providing coverage is not at all sufficient, since -- as Section I showed -- many projects that rely on trade protection turn out to be veritable cash-cows for the parent investor.

As part of the determination of eligibility, official political risk insurers should also ensure that projects meet the World Bank’s baseline environmental guidelines (including requirements for pre-investment environmental impact assessments for sensitive projects), arrange for follow-up monitoring to be carried out by qualified independent auditors, and provide for the results to be made public on a timely basis with wide local disclosure. Projects that are rejected on environmental grounds should be so-identified.

Of the 21 principal capital-exporting developed countries, only Ireland and New Zealand do not have a national political risk insurance agency that screens the applications of outward investors for compliance with the World Bank’s baseline environmental guidelines.171 (For the behavior of US OPIC on environmental screening, see Chapter 3 in this Section.)

Turning to evaluation of the effects of outward investment projects on the home economy, national political risk insurers have a legitimate right to assess the impact of providing coverage for a proposed applicant on domestic workers and communities. To accomplish this, Section IV argued that the test for support should be what would happen in the home economy if a given proposed investment did not take place.

The rigorous answer, as documented there, is that in the great majority of cases the home economy would be less vibrant, the competitive base of investor would be weaker, and the number of high-productivity jobs paying favorable wages and benefits would be smaller. Keeping firms at home – or denying them help to overcome market failures in moving abroad – would leave the home economy worse off than is the case when they are able to take advantage of opportunities around the world.

The appropriate test for home country support is not, would this outward investment project result in any job loss? The appropriate test is not even, would this outward investment project help or hurt the current net employment rate?

But some national political risk insurers are forbidden to consider support for outward investment in projects if a plant is to be closed or some workers are to be laid off. Some national political risk insurers are not permitted to provide support at all for outward investment on the part of firms in “sensitive sectors” of the home economy, such as textiles, footwear, electronics, auto parts, and steel.

171 Foreign Policy/Center for Global Development Commitment to Development Index 2005.
Such prohibitions are inappropriately restrictive – since they do not comply with the “better-or-worse-off-if-the-investment-were-not-made?” test -- and do not serve the interests of the home economy or the interests of the developing world. Developed countries with such prohibitions should receive poor marks as facilitators of FDI flows to the developing world. Six of 19 developed countries with national political risk insurance agencies apply badly-conceived home country economic tests to projects, including Austria, Greece, Japan, Sweden, and Switzerland (for the performance of OPIC in the US, see the last chapter in this Section).  

Which firms in the home country should be eligible for national political risk insurance?  

Here there has been a pronounced transformation of analytic perspective over the past decade. Originally, when national political risk insurance agencies were launched, the prevailing approach was that home country support should be limited to home country companies. But debate about “Who is US?” has transformed the notion of which firms should be eligible, shifting away from narrow nationality-of-ownership criteria to broader criteria related to the extent to which firm operations touch the lives of workers, managers, suppliers, and communities on the ground in the home economy, independent of who owns the firm.  

According to the new criteria, any firm that has a significant presence in the home market deserves support in using that home market as a hub for investment in the developing world. On this basis, companies of any national origin with a significant presence in Canada, for example, are eligible to purchase political risk coverage from Export Development Canada.  

Restricting national political risk coverage to firms that are wholly-owned (or even majority-owned) by home country nationals does not maximize the benefit from outward investment for the home country, nor maximize the benefit from inward investment for the developing world.  

In the United Kingdom, in contrast to Canada, only companies of UK origin can purchase political risk coverage from the UK Export Credit Guarantee Department (ECGD). The interests of both home and host countries would be better served if the United Kingdom’s ECGD provided political risk coverage for outward investment from any firm with a substantial presence in the UK home market. Five of 19 developed countries with national political risk insurances agencies limit coverage to nationally-owned firms, including Greece, Sweden, and Switzerland, as well as the United Kingdom (for eligibility criteria used by OPIC in the United States, see the last chapter of this Section). 

\[^{172}\] Foreign Policy/Center for Global Development Commitment to Development Index 2005. 

\[^{173}\] Foreign Policy/Center for Global Development Commitment to Development Index 2005.
Finally, the screening mechanisms that multilateral and national political risk insurers set up can be important monitors for evidence of bribery and corruption. To be sure, political risk insurers -- as a rule -- are not structured or empowered to engage in formal investigation of wrongdoing, but they can be careful to refuse to insure projects of questionable character, and watchful to turn evidence of misbehavior over to the appropriate justice authorities, as discussed infra.

**Mechanisms to Avoid Double Taxation**

A foreign investor may be exposed to double taxation if the investor is required to pay an income tax or royalty to the host government, and then again to the home government when the income from the developing country project is remitted or consolidated with its home country earnings.

Double taxation constitutes a barrier to the foreign investment process. A tax sparing agreement, or the use of a foreign tax credit, can eliminate this obstacle.

In addition, a tax sparing agreement helps the developing country to attract foreign direct investment by offering a low tax rate or a tax holiday. If a host country were to grant a 10% tax rate to foreign investors, or award a “pioneer status” tax holiday to foreign investors, the home country would simply collect the difference between the host country rate and the home country rate when the foreign earnings were repatriated or consolidated if there were no tax sparing arrangement.

Some tax regimes that avoid double taxation may be more efficient than others, but it is difficult to evaluate how much of a difference alternative approaches make. Some researchers argue that tax sparing regimes make a large difference in facilitating foreign direct investment in comparison to foreign tax credit regimes; others dispute this and argue that the two are not very different in practice.

Ten of the 21 principal capital-exporting developed countries have tax regimes that do not allow foreign investors to enjoy the benefits of developing country tax incentives, including Australia, Austria, Belgium, Denmark, Greece, Netherlands, Norway, Spain, Sweden, and Switzerland.³⁷⁴ Three of these countries do not allow foreign investors a foreign tax credit at all, but only allow them to count foreign taxes as a business expense (Austria, Belgium, and Norway). For the performance of the United States, see the final chapter in this Section.

Multinational business groups have long contended that bilateral investment treaties (BITs) are essential not only to avoid double taxation but to stimulate FDI flows more generally. But there is remarkably little support for this latter assertion. In 1998, UNCTAD tested whether the number of BITs signed by any given host was correlated

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³⁷⁴ *Foreign Policy/Center for Global Development Commitment to Development Index 2005*. 

with the amount of FDI it received. It found no evidence that BITs increased flows of foreign direct investment.\textsuperscript{175}

In 2003, Mary Hallward-Driemeier tried a retest that examined the bilateral flows of OECD members to 31 developing countries over twenty years.\textsuperscript{176} The analysis showed that countries that had concluded a BIT were no more likely to receive additional foreign direct investment than were countries without such a pact.

Driemeier then investigated whether a BIT might act as a signaling device that would draw multinational investors’ attention to a particular country, generating an increase in flows following completion of the BIT agreement. But there was no significant increase in foreign direct investment in the three years after a BIT was signed in comparison to FDI during the three years preceding the negotiation. Finally, investigating whether the presence of a BIT affected the relative amount of FDI from a given developed country to a given developing country, no statistically significant correlation emerged.

Bruce Blonigan and Ron Davies examined the evidence for both US BITs and OECD BITs using panel data that spanned a variety of bilateral country pairs over time.\textsuperscript{177} Across these various samples and numerous specifications, they too found that bilateral tax treaties failed to increase FDI flows.

\textit{Developed Country Efforts to Prevent Bribery and Corrupt Practices}

As noted in Section III, the OECD Anti-Bribery Convention of 1999 has become the central international mechanism to ensure developed country prosecution of corrupt payments from multinational investors to public officials in developing countries. As of 2005, all 30 OECD members and six non-members have enacting anti-bribery laws based on the OECD Convention, making a bribe by one of their multinationals to an official in a developing country a punishable offense.\textsuperscript{178}

Signatories to the OECD Anti-Bribery Convention then go through a two phase peer-review examination process. Phase 1 involves an assessment of the conformity of the

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country’s anti-bribery laws with the OECD convention. Phase 2 consists of one week of intensive meetings in the examined country between experts from other OECD states and key actors from government, business, trade unions and civil society to assess how effectively that country’s anti-foreign bribery laws function in practice.

As of 2005, Phase I has been completed for the 35 of the 36 signatories, with one country remaining to be examined. Eighteen countries, including the G-8, have completed Phase 2. The remainder are scheduled to be completed by 2007.

But the scope of the OECD Convention is strictly limited – requiring member states to pass domestic legislation that does no more than criminalize a direct payment to a public official by an international company to secure a contract. The partnerships with family members and cronies -- backed by sophisticated loans-to-purchase-equity-shares, overlapping payment arrangements, and deferred-gift mechanisms, documented in Section III -- would almost certainly not be caught or punished using legislation that merely met the OECD Convention standard.

The OECD’s informal “Guidelines for Multinational Enterprises” have what the OECD admits is much broader scope. In defining bribery, the Guidelines state “Enterprises should not, directly or indirectly, offer, promise, give, or demand a bribe or other undue advantage to obtain or retain business or other improper advantage.”

“In particular, enterprises should ….not use sub-contracts, purchase orders or consulting agreements as means of channeling payments to public officials, to employees of business partners or to their relatives or business associates.” To this last sentence should be added, “partnership arrangements”.

The payment structures uncovered in Section III make it clear that until the OECD Convention – and implementing laws in ratifying states – are tightened at least to the degree recognized in the “Guidelines for Multinational Enterprises”, with “partnership arrangements” added, the Convention simply does not have the capability to curb any but the most unsophisticated corrupt payments.

This may help explain why Transparency International’s 2002 Bribe-Payers’ index reported that firms from many OECD countries appear to their counterparts from other OECD countries to engage regularly in making corrupt payments, notwithstanding the 1997 OECD Convention.

Parallel with strengthening the OECD Convention, there is a need to introduce anti-corruption provisions into multilateral investor-state dispute settlement mechanisms. Oddly enough, the 2,300-plus bilateral investment treaties (BITs) make no mention of bribery or corruption, and recent tribunals that have heard states defend actions taken

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against foreign investors as justified because the latter engaged in corrupt practices have rejected this line of argument.

To put teeth into anti-corruption efforts, a new balance must be struck. Not only must international investors be protected against misbehavior on the part of host states, but host states must be better protected against misbehavior on the part of international investors.

Precedents already exist in international law – just as they do in domestic law -- to reject the validity of any contract or permit obtained by corrupt means, thus vitiating rights pertaining to such an investment (see the concluding chapter in this Section for the legal basis through which OPIC commitments evaporate when corrupt behavior is discovered). 180

In the final decision of arbitration in the Methanex case -- an investor-state dispute brought under NAFTA’s Chapter 11 -- the tribunal recognized that it had the capacity for a finding of fact of corruption even though such allegations had not been proven in associated criminal trials. 181 While the tribunal ruled that the evidence available to the members did not support a finding of corruption in this particular case, it made clear that the presumption that an investor can rely upon arbitrators to enforce a contract obtained via corrupt actions is not justified. 182 International adoption of a corruption definition along the lines of the OECD Guidelines for Multinational Enterprises would give arbitral panels a standard to decide whether an investor is entitled to protection in a dispute with host authorities.

Finally, arrangements of the kind uncovered in Indonesia have to be regularly brought into the light of day. To move in this direction, the publish-what-you-pay and publish-what-you-spend effort has to spread steadily across sectors and across borders. In particular, the Extractive Industry Transparency Initiative (EITI) must be expanded in geographical scope, and enlarged to cover infrastructure concessions as well as mining and petroleum projects.


These three steps -- tightening the OECD definition of what constitutes corrupt payments, denying investors that engage in bribery protection in international arbitration, and steadily enlarging the exposure of payment and partnership arrangements to domestic and international scrutiny – can eliminate the current hypocrisy and lay the basis for a genuine effort to combat bribery and corruption.

The objective is to allow relevant authorities – and ultimately the public – to address six questions:

1) Was a payment made?

2) If so, to whom (and what is their relationship to host country leadership)?

3) For what services?

4) Does the payment constitute a “gift”?

5) Did the payment or the “gift” affect the awarding of the investment concession, or the structure of the terms?

6) Can the entire transaction withstand technical legal – and public – scrutiny?

Developed country authorities and multilateral agencies can only achieve limited progress on their own. Vital to this endeavor is the endorsement and wholehearted participation of developing country authorities – requiring all potential investors to take meet the same standards, including public and private companies from home countries that do not require transparency or adherence to the OECD Convention. Developed countries have a role in encouraging developing countries with whom they have special relationships to take part. They can also contribute to the World Bank’s multi-donor Trust Fund to provide bilateral support to build independent monitoring capacity within individual developing countries and sponsor widespread timely disclosure. Ultimately developed countries may decide that it is counterproductive to continue to provide assistance – including multilateral financial assistance – to developing countries that do not take part in a broadened Extractive Industries Transparency Initiative, the Kimberly Process (for diamonds), and other such programs.

Other Measures to Facilitate Foreign Direct Investment Flows to Developing Countries

In some developed countries, the Foreign Service or Commercial Service is trained to help home country firms to find investment opportunities -- as well as export opportunities -- in the developing world. Corporations often follow a regular progression from supplying exports to an external market, to setting up an in-country marketing network, to assembling components within the host country. Developed countries that offer a seamless web of support in identifying export, marketing, and investment opportunities have the greatest likelihood of solidifying the competitive position of their
home firms in the host market. This is particularly valuable for smaller or less experienced firms.

Fifteen of the 21 major developed countries provide official assistance in identifying investment opportunities in developing countries, including Australia, Austria, Canada, Denmark, Finland, Germany, Greece, Italy, Japan, Netherlands, Norway, Portugal, Spain, Switzerland, and the United Kingdom.\(^ {183}\)

Other developed countries do not – or are forbidden to – engage in this kind of support for outward investors, captured by the mistaken notion that keeping investors at home will preserve home country jobs. This roster includes Belgium, France, Ireland, New Zealand, and Sweden (for the practice of the United States, see the final chapter in this Section).

Another measure developed countries can take to facilitate FDI flows to developing countries is to provide support for host investment promotion agencies. Sections I and II of this volume showed the key role that a well-staffed and up-to-date investment promotion agency – complete with real-time links to relevant ministries and satisfied investors -- can play in attracting new investment projects, even in poorer developing countries.

Financial assistance and technical support from developed countries have often made a crucial difference. The Lesotho National Development Corporation (LNDC), charged with attracting and promoting foreign direct investment, for example, was established with support from – and is owned 10 percent by -- the German Finance Company for Investments in Developing Countries. In the first three years of its existence it attracted 55 export-oriented investors, employing 32,000 workers, with exports of garments, electronics, and processed foods worth $216 million.

Fourteen of the 21 largest developed countries have provided assistance to developing states for the establishment and maintenance of investment promotion agencies; the remaining seven have not, including Belgium, France, Greece, Ireland, Italy, Japan, and Switzerland. As the Costa Rica case study in Section I showed, the United States has a commendable record in supporting investment promotion agencies.

\(^ {183}\) *Foreign Policy*/Center for Global Development Commitment to Development Index 2005.
2. Critical Reappraisal of Developed Country Policies toward International Investment

There are three areas – in addition to combating corrupt payments -- where the preceding analysis has shown that developed countries need to reconsider how they treat international investors, with the aim of improving the contribution that foreign investment can make to development.

These three areas are: separating political from commercial risk in providing guarantees to infrastructure investors, modifying the mandate for international investment dispute arbitral panels, and bringing the escalation of locational subsidies under control.

As Sections I and III have suggested, the “reconsideration” of developed country practices in these three areas opens up vast new challenges for the design of appropriate public policies. It is nonetheless important that debate on what form the required changes and reforms might take begin.

Separation of Political from Commercial Risk in Infrastructure Investment

Section III pointed out that the traditional definition of political risk envisions deliberate acts by host country authorities motivated by an intention to change the treatment of a foreign investor. Changes in external market conditions over which host country authorities have no control that reduce their capability to perform as expected, in contrast, fall under the category of commercial risk.

In recent years, however, international infrastructure investors have designed take-or-pay contracts that place risk of fluctuations in supply and demand (often along with devaluation risk) on host government buyers or suppliers, and national and multilateral political risk insurance agencies have provided guarantees specifying host country failure to perform as deriving from political will rather than economic capacity.

As Section III proposed, what is needed is a reevaluation of national and multilateral political risk guarantee products to determine how to share the burden of project difficulties that spring from cross-border financial contagion rather than from deliberate host country misbehavior, and how to separate genuine political risk from more general commercial risk during a regional economic downturn. As noted there, “work outs” do not need to result in “sell outs” for either investor or host. Of twenty electric power projects that underwent contract change between 1990-2005, eleven underwent cooperative renegotiation in which the parties involved refinanced project loans, restructured or changed fuel supply arrangements, or identified other elements of existing contracts that could be mutually readjusted.184

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Along the same lines, national and multilateral political risk insurance contracts typically specify that investment disputes be settled by commercial law arbitration. But such arbitration focuses solely on the most narrow issue of whether contracts have been broken – not why they may have been broken, or how they may might have to be modified in light of changed economic circumstances.

Section III showed that commercial law arbitral decisions often make unrealistic demands on host countries in the midst of a financial crisis, and lead international investors away from trying to find a sensible work-out that serves all parties. Modification of commercial law arbitration procedures is needed to ensure that public interests are served, as well as commercial contracts observed, when external circumstances preclude the original agreement from being honored.
Multilateral Regulation of Locational Subsidies

As Section I documented, there has been an escalation in the packages of tax breaks, incentives, and subsidies – free land, below market office space, training grants – that home countries have proffered to attract multinational investors and/or to keep home country investors in place.\textsuperscript{185} Ireland was a leader. US states such as South Carolina, Alabama, and Kentucky became active players, as did the provinces of Canada. European countries – led by Germany, to entice investment in the former East Germany – have expanded their rewards to new arrivals.

Developing countries have increased their use of incentives as well. A survey of 45 developing countries shows eighty-five percent offering some kind of tax holiday or income tax reduction to attract FDI.\textsuperscript{186}

Developing country incentive packages are typically less effective than their developed country counterparts.\textsuperscript{187} But they are no less costly. Incentives for foreign investors in Tunisia have amounted to almost 20 percent of total private investment. Revenue losses from FDI incentives in Vietnam amount to approximately 0.7 percent of GDP.

European countries have offered international companies as much as $180,000 per job created. Brazil joined the competition with incentive packages ranging from $54,000 to $340,000 per job.\textsuperscript{188}

Traditional wisdom held that multinational investors did not base their locational decisions upon tax considerations, and that there was little competition between developed country and developing country sites in any case. Both of these assumptions are being challenged by contemporary econometric research, reviewed in Section I, which shows that multinational investors are becoming more responsive to locational incentives and that the competition between developed and developing country sites is growing.\textsuperscript{189}


\textsuperscript{188} WORLD DEVELOPMENT REPORT 2005, op. cit., p. 171.

The record of developed countries in facilitating foreign direct investment to developing countries is marred to the extent that they deploy significant locational incentives to attract or hold international investors. Indeed the interests of both developed and developing countries are undermined as long as the competition in locational incentives goes unchecked.

The sensible conclusion is for both developed and developing countries to declare a truce in the battle to attract and hold international investment, then cap and roll-back the give-away programs around the world. The challenge of accomplishing this is complicated, however, because much of the investment attraction is carried out at the sub-national level, over which national authorities have difficulty exercising control even if they should desire to do so.
3. An Assessment of US Support for Foreign Direct Investment in Developing Countries

In terms of many of the policies outlined thus far in this Section, the United States plays an active role in facilitating FDI flows to developing countries.

US investors are eligible for political risk insurance via multilateral and regional banks, as well as via the Overseas Private Investment Corporation. OPIC follows the World Bank guidelines to screen for environmental impact. The United States employs a Foreign Tax Credit to prevent double taxation, and offers deferral when overseas tax rates are lower than US rates so that foreign investors do not lose tax advantages accorded to them by host governments. The US has long considered itself a pioneer in combating bribery, by legislating the Foreign Corrupt Practices Act in 1972.

Thus, it may come as a surprise to discover that the United States assiduously avoids supporting many forms of outward investment that would be particularly valuable for poor country development. And in many areas where the US government does provide support, its performance seriously lags behind what other developed countries do. Finally, the United States, like other developed countries, needs to tighten US regulations – and US monitoring – to combat bribery and prevent corrupt payments.

Removing the Constraints on OPIC

While the United States has the oldest official political risk insurance agency in the world, the Overseas Private Investment Corporation (OPIC) is prevented from participating in many projects of the kind that hold greatest potential benefit for host country development. 190

OPIC is precluded from providing political risk insurance or financial guarantees to “sensitive sector” investments of the kind where most developing countries – especially poorer developing countries -- have a comparative advantage.

By statute, OPIC cannot not assist textile and garment projects aimed at exporting more than 5% of production to the United States unless there is a already a bilateral treaty in place placing a limit on exports of textiles and apparel to the US. By statute, OPIC cannot cover agribusiness projects if the crops involved are “in surplus” in the United States and more than 20% of the output is expected to be exported to the United States.

By internal guidance, OPIC has considered all projects in the electronics industry or the automotive industry (including all auto parts) too “sensitive” to support. For the same reason, OPIC has not provided support to US investors interested in setting up Export Processing Zones, effectively precluding US companies from playing the

investor/developer role that has been such a powerful force in poorer country investment promotion, as discussed in Section II.

Where OPIC has found a way to operate in low income states, the Corporation has frequently been able to support pioneering projects with broadly positive social impact that have served as a “demonstration” model to other investors. A relatively modest $1.9 million political risk insurance policy from OPIC allowed an American investor (Agro Management), for example, to provide chrysanthemum seedlings to farmers in Uganda, set up buying stations close to the farms, and establish a communal bank to deposit payments for flower deliveries. This allowed some 19,000 Ugandan farmers to participate in this export-oriented endeavor.

But this is the exception rather than the rule. As a result of statutory and internal policies concerning possible job loss in the United States, no more than 10% of OPIC’s portfolio is located in manufacturing or assembly, or in agribusiness. Most investors in labor-intensive sectors simply do not bring their projects to OPIC for consideration.

For those projects that do get considered, the “US effects” calculation that OPIC applies to determine eligibility does not separate out proposed projects according to the test proposed in Section IV – namely, what would be the impact on the home economy if the proposed foreign investment did take place, in comparison to the outcome if it did not.

Instead, its statute simply requires that OPIC not support “runaway investments”. Since OPIC must report to Congress whether the projects insured by OPIC result in any single job loss within the United States, OPIC has defined “runaway investment” as those projects that result in any job loss even if the net job creation within the US is strongly positive.

Section IV showed that firms that engage in outward investment export more, use superior technologies, enjoy higher productivity, pay higher wages, and provide more stable jobs than similar firms that do not engage in outward investment. They provide greater benefits to their workers and communities. But this process of becoming “globally engaged” is highly dynamic, with job changes and job losses mixing together with job gains and job improvements. The preoccupation in OPIC authorizing legislation with preserving virtually every existing job at the plants of firms undertaking outward investment – supposedly as a way of enhancing the strength of the home economy -- is misguided. “No single job lost” is an implausible standard by which to test for collective benefits to the United States when diverse industries are simultaneously expanding, contracting, and reconstituting themselves to become more competitive.

What is needed is a new “US net effects” test for OPIC eligibility, approving coverage to all projects that leave workers and communities better off if the projects come to fruition than could be expected if the outward investment did not take place, but not to foreign investment projects that would leave workers and communities worse off. In the vast majority of cases – but not necessarily all – this “US net effects” test would show that firms, workers, and communities would be more competitive, with better jobs and higher levels of compensation, with outward investment than without.
An effort to reform OPIC procedures along these lines was defeated in the reauthorization struggle in 2003 as a result of opposition from the AFL-CIO.

**OPIC Support for Projects in Protected Markets**

At the same time, however, OPIC has no mechanism to screen projects so as to weed out those that rely upon host country protection. Rather, OPIC merely looks to the commercial viability of the project, and (as shown in Section I of this volume) many projects set up with shelter from competition show a very favorable estimated – and actual -- rate of return. As a result, OPIC provides support to projects that misallocate resources in the local economy, detract from host country welfare, and restrict trade (including trade with the US).

Worse still, OPIC writes political risk insurance against breach of contract for projects granted trade protection to guarantee a certain profit margin. In a recent claim (Claim of Joseph Companies, Jamaica, 1999) a US investor objected that the host government was lowering trade barriers, opening its markets to competition, and eliminating parastatal monopolies on imports, in violation of assurances given to the investor.\(^{191}\) OPIC acknowledged that these liberalizing actions contradicted promises made to investor and were therefore covered by the Corporation’s policy against breach of contract. OPIC paid the claim.

**Who-Is-Us? and Revised Eligibility Criteria for OPIC to Match the Export-Import Bank**

By now it is a commonplace to observe that globalization has changed the corporate face of the US economy. In recent years, some 5000-plus US companies have been acquired by or merged with foreign corporations. Some have no remaining US ownership (Giant Food, ADT Security Service). Others became part of the foreign corporation with US shareholders acquiring stock in the new combined entity (e.g. the Chrysler Corporation was merged into Daimler Benz, A.G., a Germany public company, and Chrysler stock owners became shareholders of Daimler Benz, which changed its name to Daimler Chrysler). Since acquiring Westinghouse, Siemens-USA has become larger than Siemens-Germany, employing more than 90,000 workers in the United States.

Many foreign companies have set up “greenfield” operations in the United States, building new plants in South Carolina or Alabama, for example, without acquiring US firms in the process.

The United States is now the largest host country to foreign direct investment in the world.

In determining “Who is Us?” in the United States, as elsewhere, an “Us” identity – “Our” livelihood, “Our” economy, “Our” country – is intertwined with the activities of a

growing number of companies with diverse national ownerships. US affiliates of foreign companies account for 21 percent of total US exports of goods, and – in many sectors – 20 percent to 30 percent of all jobs. They provide compensation 15% higher than domestic companies in similar sectors, averaging nearly $60,000 in 2005. Company funded R&D per worker in affiliates of foreign corporations is slightly higher than for domestic firms in the same sector, and much higher than for all US firms.

To enable US workers and communities to capture the benefits associated with this dynamic US-based-but-foreign-owned activity, the US Export-Import Bank has been allowed to determine eligibility for export loans and services on the basis of whether the goods that are to be exported are manufactured in and shipped from the United States. Foreign-owned firms that use the US as a base for exports are allowed to participate in Ex-Im’s programs.

The same is not true of OPIC.

To receive OPIC insurance or loan guarantees, OPIC’s statute defines “eligible investor” as US citizens, US entities “substantially beneficially owned” by US citizens, foreign corporations more than 95% owned by US citizens, other foreign entities 100% owned by US citizens, or US entities substantially beneficially owned by US citizens. OPIC has traditionally defined “substantially beneficially owned” as requiring majority US ownership.

As a result, international companies with a major presence in the United States are not eligible for OPIC coverage to set up marketing outlets or supplier networks abroad. Siemens-USA, whose US workforce of 90,000 is noted above, is not eligible for OPIC coverage. Siemens-Canada, in contrast, is eligible for coverage by Canada’s Export Development Corporation (EDC).

To enable US workers, suppliers, and communities to take advantage of the international dynamism of foreign corporations that want to use the US market as the base for outward investment, OPIC’s statute would have to be modified to include a “significant presence” test for eligibility. “Significance presence” could be defined in some simple and straightforward way such as employment of 250-or-more, or 500-or-more, workers within the US economy.

This would bring OPIC into congruence with the already-established “US Government Advocacy Guidelines” in which support for a foreign-owned US-incorporated firm is considered to be in the US national interest when the operations to be supported involve US materials and equipment and labor, and may contribute to the US technology base, to the repatriation of profits to the US economy, and/or to follow-on business that would benefit the US economy.

**OPIC and Environmental Screening**

OPIC is required by statute to assess the environmental impact of projects under consideration for political risk insurance and financing. OPIC’s Board cannot approve any action that would be likely to have a significant adverse environmental impact unless
for at least 60 days before the date of the Board vote an environmental impact assessment has been completed and made available to the Board, to the US public, to locally affected groups in the host country, and to host country nongovernmental organizations.

In determining whether a project will pose an unreasonable or major environment, health or safety hazard, or will result in significant degradation of national parks or similar protected areas, OPIC relies on the most recent guidelines of the World Bank. Where there are gaps in World Bank guidelines, OPIC incorporates relevant US federal standards, World Health Organization standards, and standards set by other international authorities.

By statute, OPIC is required to notify appropriate host country officials of all substantive environmental requirements that would apply if the project were undertaken in accordance with World Bank’s guidelines, and of all US regulatory requirements that would apply to the project if it were undertaken in the United States.

“Category A” projects receive special on-going scrutiny. “Category A” refers to projects that have a material impact on the environment, usually beyond the project site, such as large scale industrial plants, refineries, thermal power stations, chemical plants, transportation infrastructure, oil and gas production and pipelines, other natural resource production plants, waste processing facilities, and large-scale tourism development. OPIC requires all Category A project sponsors to conduct regular third-party independent audits, at least one of which must take place in the first three years.

In the midst of this rather thorough environmental screening, however, OPIC has allowed a major gap to endure, involving lack of transparency about the rejection process. Under current practice, the Corporation renders the majority of its negative decisions prior to the formal application process, without public disclosure, so as not to endanger other potential sources of financing and insurance for the rejected projects.

But if proposed projects do not reach OPIC thresholds – and the sponsors cannot, or are unwilling, to bring them up to OPIC standards – this should not be deliberately hidden from public scrutiny. As now constituted, the Corporation’s care not to reveal that a project has been rejected on environmental grounds undermines the intent of the public disclosure process. To correct this, OPIC should abandon its practice of making informal decisions about environmentally sensitive projects outside of the formal application and assessment procedures.

A “One-Stop-Shop” to Promote Exporting-and-Investing Abroad

The Foreign Commercial Service (FCS), working with the Export-Import Bank, OPIC, the Department of Commerce, and the Small Business Administration, has much under-utilized -- indeed, un-utilized -- potential to help facilitate foreign direct investment to developing countries.
The FCS does help US firms to spot export opportunities, and the US Foreign Service assists US firms to bid on some developing country contracts, but neither has been trained to identify potential foreign investment projects. This is a missed opportunity since the typical sequence is for an international company first to export to a target market, and then consider investing in a distribution or assembly facility.

What is needed is not some new bureaucracy, but rather simply to introduce investor support services into the already-functioning export-assistance infrastructure. The US Foreign Commercial Service provides export-counseling services to US firms through a network of offices in 47 states, and has officers in the US embassy in 84 foreign countries. The US Ex-Im bank is represented in six of these domestic centers in the United States. Department of Commerce specialists located domestically and overseas offer “Gold Key” custom-tailored service for US exporters planning to visit a country that includes briefings, industry reports, interpreters, and introductions to potential partners. Many states and municipalities have special export support offices. There are 19 US Export Assistance Centers (USEACs) that are dedicated to providing export promotion services that combine the Department of Commerce, the Ex-Im Bank, the Small Business Administration, and other export-related federal and state agencies.

By providing training to these export promotion officers and helping to build a “one stop shop” for exporting/investing, the US can mobilize the commercial officers involved in this export promotion endeavor to help search out those US companies that are ready to undertake foreign direct investment to complement their penetration of external markets.

Reform of the US Approach to Double Taxation?

The United States employs a world-wide system of corporate taxation, requiring that taxes be paid on income wherever generated. To avoid double taxation, the US Treasury allows a foreign tax credit for taxes that affiliates of US firms pay abroad, up to the effective US rate (a statutory rate of 35 percent but usually a lower effective rate). Whatever tax on foreign income that is owed to the US Treasury is not collected, however, until the earnings are repatriated as dividends to the US parent. This latter practice is known as “deferral,” and means that foreign affiliates can enjoy the benefits of a lower tax rate abroad as long as they invest the money saved in productive activities (not passive tax havens) and do not repatriate it to the United States.

Thus, if the tax rate in a developing country is 10 percent and the effective rate in the US is 30 percent, the parent corporate would owe the US Treasury the difference, but would not have to actually make a payment to the US Treasury as long as the parent kept reinvesting the accumulated funds abroad.

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192 USEACs are located in Atlanta, Baltimore, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Detroit, Long Beach, Miami, Minneapolis, New Orleans, New York, Philadelphia, Portland, San Jose, St. Louis, and Seattle.
Critics have long complained that this system constitutes a subsidy for outward investment by US firms, in the form of a tax-free “loan” of monies owed to the US Treasury for use abroad.

A recent version of this complaint was launched by Senator John Kerry during his Presidential campaign in 2004. Kerry proposed a plan that would keep the Foreign Tax Credit, but significantly limit deferral, with the aim of keeping investment (and jobs) in the United States.

Such a proposal, according to Gary Hufbauer and Paul Greico, performs the right diagnosis – a need to level the playing field about where to locate business operations -- but provides the wrong prescription. The fundamental problem, in their analysis, is that the US has become a relatively high-tax locale for business, in comparison to most OECD countries as well as to developing economies. A comparison of effective tax rates in 59 countries reveals that 43 have lower effective rates than the United States and only 16 have higher rates.

The limitations on deferral would place US MNCs as a further disadvantage in comparison to other international competitors, more than outweighing the impact of trying to pull US companies toward making greater use of the United States as a base for business. Foreign-based MNCs could consequently increase their lead over US companies in international markets – were any approach analogous to the Kerry proposal ever to be adopted -- giving foreign firms even more of an advantage for future expansion.

What is needed, according to Hufbauer and Greico, is to lower the effective US corporate tax rate – which Kerry also endorsed – while changing WTO rules that permit foreign governments to use border tax adjustments to encourage exports and discourage imports. This would lead multinational investors of all nationalities to choose production locations on the basis of genuine comparative advantage, rather than artificial tax benefit.

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US Leadership on Unsettled Issues in Commercial Law Arbitration

Experience derived from the Asian financial crisis – as discussed earlier in this Section -- should prompt OPIC, in collaboration with other public and private political risk insurers, to reevaluate how to prepare for project difficulties that spring from cross-border economic contagion rather than from deliberate host country misbehavior, and how to separate genuine political risk from more general commercial risk during a regional economic downturn.

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Otherwise, OPIC reserves will continue to be expended simply to bail out the large number of investors whose projects are set back by the onset of recession (as in Indonesia), rather than to compensate the smaller set of investors damaged by genuine hostile host government political acts.

This will require addressing some subtle questions, such as crafting a “force majeure” clause in official political risk insurance contracts to deal with situation of economic and financial contagion, and defining what constitutes a trigger event for paying of political risk policies in circumstances like the Asian financial crisis.

The United States can take a leadership role in devising a policy to deal with cross-border economic turn downs, instructing OPIC to seek a common solution with other national and multilateral political risk guarantee agencies.

Similarly, it has become clear that during periods of international or regional financial crisis it is dysfunctional to have the International Monetary Fund and the World Bank weighing in on behalf of austerity programs for the countries affected while MIGA, OPIC, and the official political risk guarantee community insist – via reliance on commercial law arbitration – that all contracts signed in earlier periods be respected in their entirety. The United States should join in the common effort to find new guidelines for arbitration – and mediation – that encourage fair and orderly work-outs for distressed projects.

_A US Initiative to Bring Locational Subsidies under Control_

As noted earlier, individual state governments in the United States (such as Alabama, South Carolina, and Kentucky) have been at the forefront in the escalation of locational incentives to attract or keep international company plants from leaving.

The United States needs to reverse its long-standing policy of _resisting_ efforts within the OECD to extend national supervision of investment subsidies to cover sub-national authorities.

The climbing levels of tax breaks, free land, subsidized office space, and training grants provided to international companies represents a classic example of the prisoners’ dilemma: no single government dares refuse to match the moves of others, but all would be better off if there were an international agreement to cap (and roll back) these giveaways. The United States should be a prime mover in this multilateral endeavor.

Finally, the United States needs to live up to its self-defined role as a leader in combating bribery and corrupt payments, and ensuring that FDI-derived tax revenues are not diverted into private hands in the developing world.
Putting “New” Teeth into the Foreign Corrupt Practices Act

The new discoveries reported in Section III involving current-payment-and-deferred-gift structures that American companies have used to win large investment contracts abroad show that the United States does not yet deserve the reputation it has claimed to have earned in the battle against bribery and corrupt payments.

Rather, the United States – like other developed countries – will have to tighten up the Foreign Corrupt Practices act to ensure that US companies cannot win contracts via carefully constructed payment schemes that channel funds to family members, confidants, and personal associates of rulers around the world.

The historical record since the passage of the Foreign Corrupt Practices Act shows a noticeable lack of vigor on the part of US agencies responsible for investigating allegations of impropriety, even where the channels for so-doing are already in place. What hard evidence is available suggests that an overly permissive interpretation of what constitutes bribery and corrupt payments is to blame.

A detailed look at the history of OPIC-covered projects reveals weaknesses that extend across the entire array of US programs that support US companies abroad at the Department of Commerce and the US Export-Import Bank.

Working with the US Department of Justice, the Overseas Private Investment Corporation has all the machinery needed to combat bribery and corrupt payments firmly in place. All OPIC finance agreements, for example, require that the project company comply with both US and local laws forbidding bribery and kickbacks, and maintain accounting records -- open to inspection by OPIC, as part of the Corporation’s periodic monitoring process – in a form adequate to determine whether the borrower is in compliance. A violation of such US or host country anti-bribery laws constitutes a default under the OPIC finance agreement, entitling OPIC to call the loan, suspend the commitment (if all funds have not yet been paid out), and/or proceed against collateral.

All OPIC insurance contracts likewise require the insured investor and the project company (or, in the case of an insured institutional lender, the borrowing foreign enterprise) to comply with US and local laws forbidding bribery and kickbacks. A violation of these laws entitles OPIC to terminate the insurance contract, recover any payments previously made, and/or refuse to make payment of a claim to the insured investor.

OPIC is prohibited by its authorizing statute from making any payments under its insurance program for any loss occurring as the result of the insured taking part in bribery or corrupt payments. The investor with OPIC insurance or the borrower with OPIC finance is liable moreover if there is violation of any anti-corruption law on the part of “any agent” acting on behalf of the investor or borrower. If a covered investor is found guilty, OPIC is required to suspend that investor for up to five years from all insurance, loan, guaranty or other financial assistance offered by OPIC.
OPIC’s has regular monitoring procedures, including site visits, that can include inspections of books and records by OPIC staff to spot potential corrupt behavior, to follow up on allegations made in the press (or elsewhere) regarding projects in its portfolio. OPIC has the responsibility to refer suspicious activity to the Department of Justice for formal investigation and potential criminal prosecution. Whether or not the company is in violation of the Foreign Corrupt Practices Act must be determined by a US Court, not by OPIC.

Despite the frequency with which allegations of corruption, favoritism, and financial wrongdoing have been associated with projects in the sectors where much of OPIC’s business has historically occurred – especially mining projects, oil and gas projects, and energy infrastructure – OPIC has taken this route just once – in the Enron-Dabhol case in India in 2002 – in the more than three decades since the enactment of the Foreign Corrupt Practices Act.

OPIC does not make its inquiries about allegations of corruption public. But the evidence that is available from one incident – OPIC’s follow-up to a Wall Street Journal article detailing the use of partnerships with Suharto family members to secure power plant concessions in Indonesia – shows the same accommodating stance toward partnership arrangements with family members of a host country president as revealed in the email exchanges with the Department of Justice in Section III.

“Most of the billions of dollars of US electric-power investments in Indonesia went through cronies and relatives of Mr. Suharto,” reported the Wall Street Journal.194 “Nearly all the Suharto relatives involved in the power projects got shares in joint ventures from their American partners without investing money of their own.”

On January 22, 1999, David Wofford, Senior Counselor to the President of OPIC, wrote to El Paso Energy International, citing the Wall Street Journal article, to request information about the ownership arrangements of the $40 million PT Energi Sengkang power plant (PTES).

El Paso replied that the PTES was 47 ½ percent owned by El Paso Energy, 47 ½ percent owned by an Australian public company, and 5 percent owned by PT Trihasra Sarana Jaya Purnama (Trihasra). The latter company, Trihasra -- El Paso affirmed -- was wholly-owned by Indonesian nationals, including Ms. Siti Hardijanti Rukmana, President Suharto’s daughter. The Indonesian Foreign Investment Law requires, El Paso noted, that all private power generation entities must have a minimum of 5 percent Indonesian shareholding. “Trihasra meets this requirement,” El Paso pointed out.

Trihasra’s 5 percent stake in PTES ($2 million), El Paso argued, had been “obtained in return for the fair value of services provided” during the development period for the project.

In performing due diligence on PTES prior to investment, El Paso sought independent reviews by a major US law firm and a major US accounting firm to ensure that the company was in compliance with the US Foreign Corrupt Practices Act. “Their reviews concluded that Trihasra’s ownership interest in the project did not present any compliance issues under the Act,” concluded El Paso.

This response appears to have satisfied OPIC. OPIC did not pursue the matter further, or refer El Paso to the Justice Department. In Jakarta, OPIC President George Munoz insisted that “the contracts” – including the PTES contract – “have to be honored.”

If the Foreign Corrupt Practices Act is tightened to bring it into line with the OECD’s “Guidelines for Multinational Enterprises” – to enjoin US corporations from using partnership agreements “as means of channeling payments to public officials, to employees of business partners or to their relatives or business associates” – OPIC, like the US Export-Import Bank and the Department of Commerce, will have a solid basis for rejecting PTES-type arrangements as a legitimate mode of doing business. To complement this, OPIC and its sister agencies in the US government will then have to reform the casual surveillance practices of the past, adopting procedures that are much more attentive to the possibility of malfeasance, with a lower threshold for turning cases over to the Department of Justice. The United States will then be in a position to push the Berne Union – the international association of export credit agencies and political risk insurers – to move in the same direction.

The tightening up of the Foreign Corrupt Practices Act will provide the Department of Justice, in turn, with the wherewithal to investigate possible misconduct on the part of the far larger proportion of US investments in the developing world that do not seek out OPIC coverage.

Reform of US law will add credibility to US efforts to promote “publish what you pay, publish what you spend” measures that apply uniformly to companies and governments around the world.

Not only will instances where American companies award $2 million ownership stakes to Presidents’ daughters be made public, but – unlike today -- the practice will be invalidated as an acceptable business practice.

The continuous enlargement of this new international regime – to ensure transparency and accountability for payments by multinational resource and infrastructure investors, and transparency and accountability for expenditures by host authorities – is vital to

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ensure that these investments contribute as effectively as possible to the broad welfare of
the host country.
Part Six

Conclusions and Policy Implications

The evidence reviewed in this volume provides a basis for rich commentary on the problems, controversies, and dilemmas associated with foreign direct investment and development. The details of all the major arguments cannot be easily summarized.

Drawing on the complex earlier analysis, there are seven areas in which the conclusions and policy implications are particularly pertinent for developing countries, developed countries, multilateral lending institutions, civil society, and interested citizens.

1. Promoting “Good” – and Avoiding “Bad” – FDI in Manufacturing and Assembly

The discovery that foreign direct investment in manufacturing and assembly comes in two distinct forms – full-scale plants with cutting-edge technology and management practices, often export-oriented and integrated into the supply chain of the parent; and sub-scale plants protected from international competition with older technology and management practices, and little prospect of becoming competitive in world markets – has important implications for developing country policy, developed country policy, and multilateral financial institutions.

Not only will developing country policymakers will find their economies strengthened by attracting the former, but they can now appreciate that their economies will be weakened – and growth prospects dimmed – by permitting the latter. In this context, the negotiation of greater latitude to impose performance requirements upon foreign investors in the 2005 Hong Kong Ministerial, undermining the TRIMs (Trade Related Investment Measures) Agreement in the WTO, was a dramatic step backward in the attempt to harness manufacturing FDI for development. Developing country strategists attuned to what best serves the growth of their economies and the welfare of their people will recognize that domestic content, joint venture, and technology-sharing requirements actually have the effect of locking foreign investors well behind the frontier of best practices in their industry, and limiting the creation of backward linkages and robust local suppliers.

The record of the developed world in preventing the spread of harmful forms of manufacturing investment is not at all satisfactory. It is a scandal to discover that eighteen of nineteen OECD countries with official political risk guarantee agencies -- plus their multilateral counterparts like the International Finance Corporation and the Multilateral Investment Guarantee Agency of the World Bank Group -- offer political risk insurance to foreign investment projects that depend upon trade protection to survive. The political risk insurance agencies of the United Kingdom, Canada, France, Germany, Italy, Japan -- and, not least, the US Overseas Private Investment Corporation, for example -- ask only whether applicant investors are likely to earn a profit, not whether applicant investor projects are structured to make a net positive contribution to host country welfare. Since boutique plants in protected markets are often highly profitable,
they are allowed to qualify for official political risk insurance coverage. This practice should cease: instead of merely calculating whether a given project will make money for the investor, developed country and multilateral guarantee agencies should instead screen out projects that will fail to be commercially viable without protection from competition.

2. Supporting Effective Export Processing Zones and Investment Promotion Agencies

To help poorer developing countries to “get started” in harnessing FDI for development, it is not enough simply to counsel would-be hosts to liberalize their trade and investment policies, so as to attract firms in low-skilled industries. Developed country assistance has often played a crucial role in helping poorer countries to create well laid-out industrial parks and Export Processing Zones, served by reliable infrastructure, and backed by well-staffed and efficient Investment Promotion Agencies with up-to-date websites and links to key officials and satisfied investors. But six of nineteen developed countries with national political risk insurance agencies provide no assistance for Export Processing Zones or Investment Promotion Agencies, and refuse to cover labor-intensive foreign investment of most interest to poorer countries. At the bottom of the list is the Overseas Private Investment Corporation of the United States. OPIC denies support for investors that want to set up and manage Export Processing Zones, and will not consider political risk coverage for textile or agribusiness investors, or projects in “sensitive” sectors such as electronics or auto parts.

While labor-intensive FDI operations in Export Processing Zones have historically been associated with poor worker treatment, the evidence shows that denial of core labor rights does not act as a magnet to attract investors. Poorer developing countries have received valuable assistance from the International Labor Organization in designing labor regulations that cover all sectors of the domestic economy, including EPZs. Civil society groups from both developed and developing countries have a valuable role to play in independently monitoring the observance of core labor standards, and directing the spotlight to abuses. Developed countries must not only ensure that their own investors do not engage in abusive worker practices but must bring pressure against others within their ranks who lobby against the observance of core labor standards (like the confrontation between the US and the Japanese embassy in Bangladesh, and the US and the Korean embassy in Pakistan).

There is a powerful synergy between support for effective investment promotion programs and improvement in the treatment of workers. When countries are able to move up from the very least-skilled FDI activities to more sophisticated operations that require the investors to hire and retain slightly higher-qualified employees, those foreign companies with the more advanced products not only incorporate better human relations practices into their own plants but raise the level of worker treatment across all plants in their zones or industrial parks. Developed country support for effective Investment Promotion Agencies – and international donor support for vocational training institutions to upgrade worker skills for domestic and foreign businesses – spill over therefore into improvements in worker-management relations more broadly.
3. Screening for Environmental Standards

To ensure that foreign investment projects meet basic environmental standards (as incorporated in the World Bank guidelines), official political risk insurers should insist upon pre-investment environmental impact assessments for sensitive investments, and upon follow-up monitoring by certified independent inspectors, with results made public. Here the record of the twenty-one major capital-exporting countries is better than was true for distortionary import-substitution projects. Only Ireland and New Zealand do not have an official political risk insurance agency to conduct screening for environmental impacts.

In the case of the United States, however, the Overseas Private Investment Corporation has adopted the practice of notifying investors of negative decisions due to environmental objections on an informal basis prior to formal application-and-rejection, so as to avoid public disclosure in case the sponsors want to obtain financing and insurance elsewhere. But if proposed projects do not meet OPIC standards – and the investors are unable or unwilling to improve environmental compliance so that the projects will pass – this fact should be disclosed to the public, not hidden from view. OPIC should therefore review all projects formally as its regulations already specify, and make those that are rejected for environmental reasons public.

4. Combating Corruption and Enhancing Transparency in Extractive Industries and Infrastructure

Perhaps there is no area more important for developing country-developed country-multilateral financial institution-civil society cooperation than improvement in mechanisms to make certain that extractive industry and infrastructure investments provide benefits that accrue to broad segments of the host country population. Foreign investment in the extractive sector exhibits a sad record of becoming a “resource curse” in which powerful elites divert revenues to serve their own interests while broader social needs are starved for support. But this need not be the dismal outcome -- host countries with reasonably competent and transparent tax systems have managed to use natural resource rents to serve far-reaching development objectives.

The Extractive Industries Transparency Initiative (EITI) has taken first steps – important first steps – to establish a framework within which multinational investors make public what payments they make and host authorities make public what revenues they receive and where those revenues are spent. To be effective this framework requires company-by-company and country-by-country breakdowns, including all investors (from China, Russia, India, for example, as well as from OECD home countries), on a timely basis and in a form that can be readily understood and monitored by local citizens. While the EITI project is still at an early stage, it has received much needed support from the World Bank, which provides a secretariat and has established a multi-donor Trust Fund to train host country authorities and civil society groups in audit and disclosure. To make a meaningful impact, however, developed country governments, civil society watchdog
groups, and multilateral lending agencies will have to maintain concerted pressure so that a steadily growing number of countries have not only signed on to the EITI, but are actually taking effective steps to implement the goals. Only actively-participating EITI countries should be eligible for projects receiving any kind of official support (guarantees, political risk insurance, funding).

Extractive industries and infrastructure projects rank near the top of all corruption indexes. The evidence presented here suggests that corrupt payments in infrastructure – and quite possibly natural resources – are even more troublesome than even the most cynical mind can imagine. The deferred-gift-and-current-payment arrangements with friends and family members of ruling elites, awarded as a condition for receiving infrastructure concessions on favorable terms -- documented for the first time in earlier pages -- did not put investors from the United States, Europe, or Japan in jeopardy of prosecution via the Foreign Corrupt Practices Act or other home country legislation consistent with the OECD Convention to Combat Bribery. This suggests that the entire G-8 effort to stop corruption can easily be circumvented.

What is needed is a broader definition of corruption on the part of signatories of the OECD Convention, with precise tests to operationalize the definition so that government authorities, judges, multilateral lenders, dispute-settlement and review bodies, civil society representatives, and publics “know corruption when they see it”. Key to stopping corrupt payments, then, is affirmation of the principle of international law that investors who come to arbitral proceedings with contracts obtained by corrupt means will not find those contracts respected or enforced. This will make even investors from home countries where enforcement of anti-corruption regulations is weak or non-existent think twice about the consequences of using corrupt payments to secure infrastructure or natural resource concessions.

Reform also is required in the way in which arbitral tribunals and official political risk insurers apportion the responsibility of international investors and host authorities to deal with project difficulties when those difficulties derive from cross-border financial crises rather than deliberate misbehavior on the part of the host. When external market conditions over which host authorities have no control degrade their capacity to perform as expected – a situation normally considered to be an integral part of commercial risk – the international system of contract arbitration ought to encourage all sides to engage in a sensible workout rather than requiring host authorities to make immediate hard currency payouts to investors in the midst of national emergency.

5. Halting the Escalation in Investment Incentives

Equally pressing is the need to begin to bring the award of locational incentives offered to foreign investors under international control. Not only has there been an escalation in the level of tax breaks and other giveaways developing country hosts proffer in the hope of attracting international companies, but the evidence shows increasing competition between developed- and developing country sites for FDI. Both rich and poor states would benefit from an international agreement to cap, and roll back locational incentive
packages. Developing country governments could then spend what resources they have to improve the investment climate more generally, building vocational training institutions for workers and strengthening infrastructure. To be effective, the negotiation of an international system of restraint on locational incentives would have to bring the offerings of sub-national states, provinces, and municipalities under a common discipline.

6. Evaluating Outward Investment from Developed Countries

It is heartening to discover that the positive contributions foreign direct investment can offer to developing countries do not come at the expense of economic wellbeing in the home countries where the investors are headquartered. Instead there is a win-win dynamic that benefits workers as well as companies on both sides of developed- and developing country borders. Multinational corporations that engage in outward investment to the developing world export more goods and services, offer more “good jobs” with higher wages and benefits, and provide more stability for the communities where they are headquartered than counterpart firms that simply stay at home.

Before providing official support for outward investment, such as offering government-sponsored political risk insurance, developed countries have a legitimate interest in assessing the impact of any particular investment project on the home economy. The appropriate test for support should then be what would transpire at home if the investment did not go forward. In the great majority of cases, the rigorous answer is that economic activity would be less dynamic, job composition less favorable, and the competitive position of the home economy weaker. Thirteen of nineteen developed countries with political risk insurance agencies recognize this when they screen outward investment projects prior to granting coverage; six do not (Austria, Greece, Japan, Sweden, Switzerland, and the United States).

Worst among these is the US Overseas Private Investment Corporation. OPIC does not support an outward investment project if there will be any single job lost even if the net job creation within the United States falls clearly in the plus-column. OPIC needs to replace its current “US effects” calculation with a common sense application of the will-the-home-economy-be-better-or-worse-off? test.

7. Embracing the Spread of Global Supply Chains

The benefits of foreign direct investment for both developed and developing countries embedded in the globalization of supply chains for manufactured products examined here are so abundantly positive that home countries, like host countries, should embrace the outward spread of foreign direct investment under competitive conditions throughout the developing world.

This means home countries should help firms based in their countries to find investment as well as export opportunities abroad. Since corporations typically follow a pattern of exporting, then setting up an overseas marketing mechanism, and then assembling components in a given developing country economy, most developed countries train their
Foreign Service or Commercial Service to provide a seamless web of services as home country firms move from exporting to investing abroad. Fifteen of the largest twenty-one developed countries help companies find investment opportunities and well as export openings in international markets. Officers in the US Commercial Service, in contrast, are forbidden to provide such support for would-be investors. Belgium, France, Ireland, New Zealand, and Sweden join the roster of developed countries with misguided regulations aimed at keeping investors at home in the illusory hope that this will make the home economy stronger.

To maximize the win-win interaction between developed and developing country markets, firms of any nationality with a major presence in a given developed economy should be able to use that developed country market as a platform for outward investment. A German company like Siemens should find its Siemens-UK affiliate, its Siemens-Canada affiliate, and its Siemens-USA affiliate eligible for official political risk insurance, for example, in each of these developed country jurisdictions. But this is true only for Canada; coverage for Siemens-USA and Siemens-UK is rejected on nationality-of-parent-firm grounds by the United States and the United Kingdom. Five of nineteen developed countries with national political risk insurance agencies (including the US and the UK, as well as Greece, Sweden, and Switzerland) limit their coverage to firms of their own nationality.

For all the positive benefits, the globalization of trade and investment creates losers as well as winners, however, in both developed and developing countries. The challenge of coming decades therefore is to strengthen training, retraining, and adjustment mechanisms, as outlined here, to cushion the burdens of globalization in richer and poorer countries alike. Trying to retard or prevent the globalization of industry, in contrast, is both fruitless and counterproductive. The interests of common citizens on both sides of North-South borders are not served by locking companies and their employees in inefficient and uncompetitive economic activities.

The world community need not be hesitant and defensive towards the globalization of industry under reasonably competition conditions. Quite the contrary, a more vigorous, energetic, and “pro-active” approach to integrating global supply networks will serve the interests of firms, workers, and communities in both developed and developing countries.
### TABLE 1

FDI Inflows to Developing Countries 2004

<table>
<thead>
<tr>
<th>Country</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Top 20</strong></td>
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<td>China</td>
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<td>Mexico</td>
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<td>Nigeria</td>
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<td>Angola</td>
<td>2048</td>
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<tr>
<td>Taiwan Province of China</td>
<td>1898</td>
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<tr>
<td>Saudi Arabia</td>
<td>1867</td>
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<tr>
<td><strong>Total Top 20</strong></td>
<td>178057</td>
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(67% of total FDI flows to developing countries)

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<th>Country</th>
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<td>Peru</td>
<td>1816</td>
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<td>Viet Nam</td>
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<td>Venezuela</td>
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<td>Sudan</td>
<td>1511</td>
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<td>Egypt</td>
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<td>Ecuador</td>
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<td>Syrian Arab Republic</td>
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<tr>
<td>Country</td>
<td>FDI Flows</td>
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<tr>
<td>----------------------------------</td>
<td>-----------</td>
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<tr>
<td>Croatia</td>
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(117% of total FDI flows to developing countries)

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<td><strong>Total Third 20</strong></td>
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(5% of total FDI flows to developing countries)
TABLE 2  
FDI stocks in Developing Countries

(Millions of dollars)

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<th>Country</th>
<th>1990</th>
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(66% of total FDI stocks in developing countries 2004)

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<td>Second 20</td>
<td>Third 20</td>
</tr>
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<td>(12% of total FDI stocks in developing countries 2004)</td>
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<td>(4% of total FDI stocks in developing countries 2004)</td>
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