NEGATIVE AND POSITIVE EFFECTS OF FOREIGN DIRECT INVESTMENT

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Abstract
The attraction of foreign direct investments (FDI) is often underlined as a precondition for a successful economic venue by most governments of less developed countries. Strategists in high developed countries seem to be more cautious. Loudly arguing for a free movement of capital western governments do a lot in restricting the entrance of foreign investors to their own market. Moreover, maybe they have a good reason of doing so.

The aim of the paper is to represent a theoretical framework for measuring economic and welfare effects of incoming FDI.

The objective of the paper is to present and critically evaluate different theoretical approaches to FDI and their economic impacts.

The conclusions of the paper are that the effects of FDI can be both positive and negative. They depend on type of FDI (greenfield FDI has more positive exte rnalities then M&A actions), sector, scale, duration, location of business, density of local firms in the sector and many other secondary effects. Rather than proposing narrowly defined pro-FDI policies, attractive terms to investors should be seen as part of a country’s overall industrial policy and be available on equal terms to all investors, foreign as well as domestic.

Creating a theoretical framework for better understanding the impacts of FDI this paper might contribute establishing more realistic approach when attracting the foreign direct investment to domestic markets.

Keywords: Foreign direct investment, international economics, economic effects of FDI on a host country.

Introduction
The international movement of capital, in all variety in forms, aspirations and impacts, is the prominent feature of the economic landscape. Facing deep economic crisis and seeking after effective ways of recovery governments are supposed to be more attentive to economic and not political rationale in their decision-making. It gives for scientists a hope to be heard and motivation to move forward.

Two main types of international capital movement can be distinguished. First is international borrowing and lending which can be seen as intertemporal trade. Country, abundant with capital, exports future consumption at a price of interest rate. Borrowing country imports current consumption at the same price (Krugman, Obstfeld, 1994). The other part of international capital movement takes a different form, that of foreign direct investment. In most common sense, foreign investment is international capital flows in which a firm in one country creates or expands a subsidia ry in another. To put it in other words, it is a measure of foreign ownership of productive assets, such as factories, mines and land.

The politicians in our home country seem to have no doubt about the growth effects of foreign capital. The world economic literature and numerous empirical researches proved that positive effects of FDI are often overwhelmed by negative ones. Positive effects of FDI are more featured in case of greenfield investment. When FDI takes a form of simple merge and acquisition (M&A) actions positive externalities are much lower if not negative.

In the early stage of market econo my, foreign direct investments may produce some externalities in the form of higher employment rates and technology transfers, often filling the “idea gaps” between old and emerging market economies. Nevertheless, they often cause a lot of harm too as not a charity but the aspiration to earn more via cheep(er) resources- land and labor is the primary aim of investors. Foreign investors can reduce employment by dismissing local workers, by crowding out local businesses that cannot compete with multinationals; technology transfers may not occur if the degree of market integration is insufficient; positive capital flows often turn to negative if investors use cheep local raw materials and resources and sell expensive final goods.

In the years of booming economy, domestic producers in advanced economies are strong enough not to be forced out of business by foreign competitors. The effects of FDI became more positive. Enhanced competition, knowledge and technology spillovers, financial stability of incoming investors can bring externalities that are more positive.

In a high turbulence, economic environment governments need to be strategic and more calculative inviting multination al competitors to operate side by side with home industry. According to numerous literatures (Lipsey, Pourvis, Courant, 1994; Epstein, 1999, Han X.Vo, 2004), effort to attract investment by subsidies and tax breaks can lead to substantial reduction of government revenues, which could otherwise be used to invest in education and infrastructure what ultimately fastens economic growth and increases total welfare.
Manning & Shea (1989) argue that strong economic rationale must lay behind the incentives to attract the FDI, as the economic impact of foreign direct investment is dependent of what form it takes. This includes the type of FDI, sector, scale, duration, location of business, density of local firms in the sector and many other secondary effects. One more aspect that is important is that FDI might serve not only a way of doing money, but also a way of acquiring a certain control, both economical and political, in the host country (Krugman, Obstfeld, 1996). Mažeikių Nafta -Williams- Yukos story can serve as a brilliant example of such concern.

On an empirical level, there is a body of evidence that suggests possible positive correlation between FDI and economic growth in developing countries. Yet, while much evidence indicates a one-way causality between FDI and growth, there are many indications that the causality may run both ways (Han.X.Vo, 2004). The evidence also appears to suggest that FDI is favorable to economic welfare only if appropriate conditions exist in the host economy. This includes such factors as adequate absorptive capacity and human capital, a capacity of domestic businesses to face and hold out foreign competition, abundance of projects and market gaps that cannot to be filled up by home producers (Lipsey, Pourvis & Courant, 1994; Epstein, 1999; Han X.Vo, 2004).

Therefore, the article analyses different approaches towards this particular form of international capital movement, namely foreign direct investment.

The economic effects of foreign direct investment

FDI was an important source of developing country external finance for about 25 years after World War II. Lithuania skipped that period under the veil of command economy. Over the 1970 global role of foreign direct investment declined in importance. During the early 1980s direct investment declined in volume further. FDI in developing countries (this includes Latin America, Asia and Central and Eastern Europe) made a comeback in about 1994 (Krugman, Obstfeld, 1996; Han.X.Vo, 2004)). The reason of eased restrictions on FDI was diminishing lending of commercial banks to developing economies. The composition of external capital underwent a dramatic transformation during this period. Because of the Asian and Russian financial and economic crises, official capital flows in these countries either stagnated or declined. In their place, private capital flows became the major source of external finance for a good number of emerging market economies. Foreign direct investment accounted for only about 30 per cent in early 1980s but over 60 per cent of private capital flows in 2000 and next few years then (Carkovic, Levine, 2002).

Latest picture is different again. Amid a sharpening financial and economic crisis, global FDI inflows have made one more significant slide down. This slide was from historic high of $1,979 billion in 2007 to $1,697 billion in 2008, a decline of 14%. The slide continued into 2009. Preliminary data suggest that FDI fell a further 44% compared with their level 2008 (World Investment Report, 2009).

Nerveless, there is a good chance that foreign direct investments will increase rapidly at the first signs of economic stability. Moreover, there is a good chance that the effects of such actions will be very different (depending from countries and firms involved) and not always positive for both investors (core) and host economies.

Theory provides conflicting predictions concerning the effects of direct foreign investments. Several approaches regarding the effects of FDI exist: Neo-liberal, Keynesian, so called dependency and new dependency schools are among best-known ones.

Neo-liberals have a number of arguments defending foreign direct investment and explaining how they are beneficial for developing country as they contribute to development. They advocate free flow of capital arguing that it ensures economic efficiency; allows capital to seek the highest return across the borders; fastens economic growth as the free flow of capital reduces investors risk enabling them to diversify their investment better.

Pro- FDI economists assert that the result of coming FDI is limited ability of host government to implement bad policies. If the government tends to do so. Moreover, that foreign flow of capital might spread the best practices of corporate governance, accounting rules, and legal traditions to less developed countries (LDCs) (Ciburiene& Zaharieva, 2006).

Some more arguments used by supporters of FDI are that they, firstly, enable technology transfer in form of capital inputs, which could not be achieved by trade (Brock, Urbonavicius, 2008). Secondly, via FDI a competition is likely to be encouraged in domestic input markets. Thirdly, FDI contributes to human capital development as foreigners engage in employee training. In addition, profits from corporate taxes may be used to encourage host country’s development while investing in infrastructure for example. In addition, sometimes the investment from a core country encourages domestic investment as well (Bernatonyte, Normantiene, 2009).

In IMF World Investment Report (1999) we can find a number of ways stated in which FDI encourages development. In addition to already mentioned FDI brings in financial resources, which are
scarce in receiving country, creates new jobs, increases exports by raising efficiency and enhancing marketing opportunities, increases the availability and reduce the costs of public utilities, consumption goods and investment goods.

There is one more argument in favour of foreign direct investment that has some practical grounds. FDI has an advantage over other investments such as portfolio or loans as it proved to be much more resilient in times of economic crisis. During financial crisis of 1997-98 it was stable compared with other types of investment especially short-term, which were subject to large reversals. The same was apparent during Mexico crisis and Latin American debt crisis of 1980 (Loungani, Razin, 2001). On the other hand, latest events show that during recent crisis some large transnational companies, in example American car producers who were broadly settled in European Union (Spain, Poland, England), are closing European factories paying little attention on huge negative economic and social distortions.

While claiming that FDI benefits receiving country, encourages growth and development, Neo-liberals would say that countries should open up and let the market to work freely; that all the efforts should be concentrated on attracting FDI because it means development of the country; that every country should welcome FDI because it will improve economic conditions and increase potential of the receiving country’s development (Sabonienë 2009). Implementation of this purely Neo-liberal pro-direct investment policy seems to be the only approach recognized by Lithuanian authorities. At least theoretically.

While admitting that benefits mentioned above can be provided by FDI many economists have reasonable doubts whether it happens every time in every country. Many scientists strongly disagree that one size fits all. That particular, more cautious approach is characteristic to representatives of so-called Keynesian school.

Keynesians argue that if FDI brought benefits in one country it does not necessary mean that the same will happen in another. Many things depend on prevailing conditions in receiving country. This means that the effects should differ not only across countries but also within countries at different time as conditions change (Lipsey, Pourvis & Courant, 1994; Epstein, 1999; Sims&Lake, 2000; Han X.Vo, 2004, Buozite-Rafanaviciene, Pundziene, Turauskas, L. 2009).

Advocates of Keynesian approach believe that there exist market failures what means that free market itself cannot ensure efficiency. Firstly, information is not always perfect. Insufficient or incorrect information can lead to attraction of insufficient or wrong kind of investment. Secondly, sometimes interests of investors diverge from interest of receiving economy. That is why government regulations must be in place.

Increased competition may be beneficial for the host economy, however, not always. Coming international corporations may push out potentially more productive local business as they are yet not able to compete. In that case many jobs might be lost instead of creating. According to Loungani & Razin (2001) and Kazlauskaite & Buciuniene (2008), therefore government protection of local activities is needed.

When attracting FDI governments can use tax cuts, subsidies and many other means. When deciding to slow down the volume of incoming foreign capital governments most commonly use institutional barriers of FDI: ownership restrictions, rate of return restrictions, project approval requirements, trade and financial restrictions etc. China’s government proved as very rational decision maker in attracting FDI when economic rationale suggested they should and hampering the flow foreign capital when positive effects approached the apex (Blakman and Wu, 1998).

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

Countries not clearly understanding all the effects that FDI can bring to their economies sometimes engage in such kind of actions which ultimately can actually hamper growth. Epstein (1999) claims that countries trying to attract investment by subsidies and tax breaks can lead to substantial reduction of government revenues which could otherwise be used to invest in education and infrastructure what ultimately creates attractive environment to FDI itself, fastens economic growth and increases total welfare. Such environment may be even more important than tax breaks. Finally, the country finds itself in a situation when it is not attractive to FDI though their actions should have attracted it.

Authors, who argue that developing countries should try to attract FDI, agree, that rather than doing so by giving away the candy store in the form of subsidies and tax breaks, developing country governments should mobilize resources for 'infrastructure and labour resources' that will complement the economic structures and needs of the particular developing country. They should make efforts to inform the world of these resources
and opportunities to attract different investors, both local and foreign. Governments should bargain with TNCs to ensure that these investments contribute to the long term and dynamic benefit of the developing country.

Finally, not all types of FDI equally contribute to the development of local economy. As it is stated in World Investment Report 1999, “greenfield investment are likely to encourage development most while mergers and acquisitions (M&A), that entail a simple change of ownership can be of dubious value”. The same idea is underlined in the works of Xan.X.Wo (2004), Loungani & Razin (2001), Snieska (2008) and many other authors.

Unfortunately, time when greenfield investment was a major form of foreign direct investment is in the past. In the last two decades more and more FDI has taken a form of mergers and acquisitions of domestically owned firms by foreign-owned firms. Most FDI that come to Lithuania have a form of M&A too.

Xan X.Wo (2004) presents the principles of so-called "dependency" school that can not be left aside. Representatives of that approach argue that FDI benefits the core industrial economies at the expense of the peripheral underdeveloped countries. As a result FDI can be contributing to increasing world inequality instead of giving positive externalities of FDI.

According to the dependency school, in the long-run, FDI tends to impede economic growth and development of recipient economies. Although underdeveloped countries lack capital and industrial technology, they often are rich in natural resources and/or inexpensive labour. While income or wealth is created in the host country, it does not lead to an accumulation of wealth that would benefit the host economy. On the contrary, this wealth is transferred to the core countries. Consequently, the core stands to benefit from this structural dichotomy of the host economy because the foreign sector (i.e., the sector associated with FDI) does not benefit the rest of the host country because of lack of integration. Therefore, as the argument of Han X. Vo (2004) runs, there are cases when it is in the interest of the core countries to keep the periphery underdeveloped and dependent on the core.

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

All cases mentioned above proved that incoming FDI needs more thorough examination and decisions about policy towards FDI should not be simply straightforward. Greenfield foreign direct investment really can contribute to development of host economy (Snieska, 2008). However, some control over them is essential in order to ensure that a country will benefit. M&A investment can not only contribute to the development but even impede the economic growth of the particular country.

As a final note of this theoretical framework can be statement of different authors developing countries should focus on improving the investment climate for all kinds of capital, domestic as well as foreign (Epstein, 1999, Loungani, Razin, 2001, Blomstrom, 2002). Effective investment packages should be part of countries industrial policy and be available on equal terms to all investors (Martinkus, Lukasevicius, 2008). The idea of attracting foreign direct investors as a special effort lies behind the economic rationale.

Conclusions

1. The economic rationale for offering special incentives to attract FDI derives from the belief that it will facilitate faster economic growth; produce externalities in form of larger employment, technology transfers, skills to local industry, boosted productivity or filled “idea gaps” between rich and poor countries.

2. Strong economic rationale must lay behind the incentives to attract the FDI, as the economic impact of foreign direct investment is not always positive. The impact of FDI is dependent of what form it takes. This includes the type of FDI, sector, scale, duration, location of business, density of local firms in the sector and many other secondary effects. Greenfield FDI has more positive externalities; M&A proved to have little positive and often negative effects to host economies.

3. One more aspect that is important is that FDI might serve not only a way of doing money, but also a way of acquiring a certain control, both economical and political, in the host country.

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

5. Large country is able to affect its trading partners' accumulation of capital, and so it can alter future market conditions. A danger in attracting FDI is that capital movements can be regulated by perfectly discriminatory policy to maximize the welfare of the large country.
6. Individual strategy needs to be created and properly implemented what would ensure that FDI will provide those benefits and local economy will be able to absorb them. But governments may be imperfect as well as market. The question is then whether market or government failures are more costly for the economy’s growth and development.

7. There are cases when incoming capital together with foreign know-how may have positive impact on other domestic firms, not only those receiving a capital from abroad. On the other hand, there is no clear evidence that FDI always has an advantage over other kinds of investment, like loans for developing local businesses.

8. The use of investment incentives focusing on foreign firms is not a recommendable strategy. The main argument in support of this is that the strongest theoretical motive for financial subsidies to inward FDI tends to be based on external effects such as spillovers of technology and human capital, which do not follow automatically from foreign direct investment.

9. Incentives of motivating economic activities should, following the same logic, focus on those activities that create the strongest potential for spillovers, including linkages between foreign-owned and domestic firms, education, training and R&D. Rather than proposing narrowly defined FDI policies, attractive terms to investors should be seen as part of a country’s overall industrial policy and be available on equal terms to all investors, foreign as well as domestic.

References


