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Making FDI Work for the Poor

Taffere Tesfatchew
Karl P. Sauvant, *Columbia University*

Making FDI work for the poor

Foreign direct investment is often seen primarily as a source of capital. But foreign companies also bring technology, knowledge and employment opportunities. They create linkages with local enterprises – and thus help build a competitive domestic enterprise sector. However, to maximise the benefits from FDI, poor countries need to design intelligent investment strategies. Investment to be attracted must fit local development priorities.

[By Taffere Tesfachew and Karl P. Sauvant]

The role of domestic investment in meeting the Millennium Development Goals is widely acknowledged. The question examined in this article is how foreign direct investment (FDI) can contribute to poverty reduction. It argues that FDI too can play an important role. The interface between FDI and poverty reduction, however, is neither simple nor automatic. Furthermore, not all FDI brings the desired benefits. Maximising the positive effects of FDI requires careful and intelligent planning. However, for poverty-stricken countries, attracting FDI is indispensable for at least three reasons: to escape the dilemma of the poverty trap, to participate in the international production system, and to benefit from the transfer of knowledge and technology.

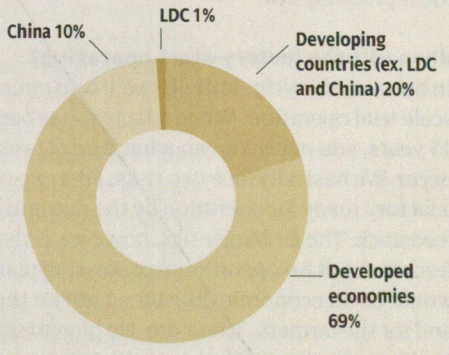
In poor countries, domestic capacity to finance development is extremely limited. A recent UNCTAD study on the least developed countries (LDCs) reveals that the domestic resources available to finance investment and public services in "poor" LDCs and the "poorest" LDCs are about 24 percent and 15 percent of GDP, respectively. The average for non-LDC developing countries is about 35 percent; for emerging economies even 40 to 45 percent.

The low level of investment in LDCs reflects the low level of income and savings capacity. The average domestic savings rate in the "poor" LDCs is around 12 percent, only half that of non-LDC developing countries. The situation in the poorest LDCs is even worse: no more than 2-to-3 percent. These countries are caught in a poverty trap. Relying on external resources is therefore unavoidable. Official development assistance covers a large proportion of the domestic resource gap. But private capital flows, and FDI in particular, have also come to play an increasingly important role lately.

Benefiting from internationalised production

In the past three decades, the role of FDI and transnational corporations (TNCs) in the global economy has expanded significantly. Worldwide there are now over 61,000 TNCs, with at least 900,000 foreign affiliates. In 2003, TNCs employed over 54 million workers in their foreign affiliates, compared to 19 million in 1982, and their total sales were in excess of US$ 17 trillion, up from US$ 3 trillion in 1982. All these activities are the results of massive inflows of FDI, reaching nearly US$ 1.4 trillion in 2000. Since then, flows have declined, although they picked up again slightly in 2004, to US$ 612 billion.

FDI inflows in selected regions
(percent of global FDI inflows, 2003)



Source: UNCTAD

The regional distribution of FDI flows is highly slanted towards the developed world. Total FDI inflows to LDCs represent just one percent of total world flows (see figure). But inflows to the developing countries have increased considerably.

Photo: Gilles Mingasson/Liaison/Getty Images

Intel plant in San José: Costa Rica wanted high-tech and got it – thanks to intelligent investment incentives.

FDI flows are often viewed primarily as sources of capital. But with the appropriate policies, FDI can contribute to the transfer of other tangible and intangible assets. These typically include technology, skills, management and marketing expertise. FDI also introduces new products and production processes. Its involvement in extractive industries has in some cases led to the development of essential infrastructure, although in other cases it has led to an enclave environment with limited impact on the local economy. It can also provide access to external markets. The creation of employment is another reason for attracting FDI.

One important caveat must be added, however. Targeted policies and investment promotion strategies are needed to translate these potential benefits into reality. Each country must assess and promote the types of foreign investment that will enable it to maximise benefits. The trade-off between the cost of attracting FDI and the benefits needs to be carefully considered. Restrictive policy regimes obviously do not encourage FDI inflows. At the other extreme, too generous incentives that disproportionately favour FDI can drain a country's meagre resources without matching benefits, disadvantage domestic firms, or trigger a "race to the bottom" if other countries compete with each other.

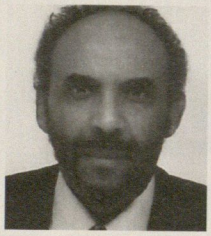
Designing intelligent FDI strategies

In designing an investment promotion strategy to attract FDI, it is essential to take into consideration the country's national development priorities and objectives. It is not unusual that a country's development objective is to develop the rural sector by encouraging commercial agriculture for export while the investment promotion strategy is focused on attracting investment into mining and manufacturing. The country Investment Policy Reviews that UNCTAD conducts at the request of member countries confirm this mismatch repeatedly.

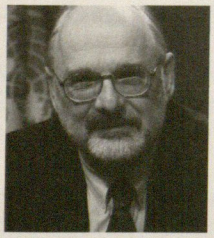
However, there are also many examples of "intelligent" FDI strategies. Costa Rica is one. Before elaborating an investment promotion strategy, the Costa Rican Government conducted a major review of the country's strengths and weaknesses in terms of skills and capacity, its resource endowment, its position in the region in terms of markets, the economic activities in which competitive advantages could be developed, et cetera. On the basis of this review a national development plan was formulated, which focused on making the country an attractive location for information technology-related activities. At the same time, an investment promotion strategy was designed with a view to targeting FDI by IT firms. In fact, even the type of FDI to be attracted was targeted by offering the microprocessor manufacturer Intel a special package to invest in Costa Rica, which it subsequently did.

As labour surplus societies, poorer countries should initially focus on labour-intensive activities as this would give them cost competitive advantages and allow them to attract TNCs seeking labour-intensive operations. But this is not the end of the story. The

Investments in tourism can generate a great number of jobs through forward and backward linkages. Security guard in a hotel in Swedru, Ghana.



Taffere Tesfachew
is Chief of the Policy Review Section, Division on Investment, Technology and Enterprise Development, at the UN Conference on Trade and Development (UNCTAD).
taffere.tesfachew@unctad.org



Karl P. Sauvant
is Director of UNCTAD's Division on Investment, Technology and Enterprise Development.
karl.sauvant@unctad.org

ultimate objective for these countries is to move up the value ladder in the production process. This calls for improvements in productivity, which incidentally comes naturally as incomes increase, wages rise and companies are forced to pay more to their labour force.

For example, it was a deliberate policy of the governments of the Republic of Korea and Malaysia to raise wages systematically in order to force companies to improve productivity by introducing new technologies and training workers. At the same time, new areas of labour-intensive production activities for exports were also encouraged in order to absorb semi-skilled workers who became redundant because of technological upgrading.

Creating linkages

FDI can create semi- and unskilled jobs that are accessible to the poor. Linkages between foreign affiliates and local enterprises are the most effective mechanism through which the positive impact of FDI is transmitted to the local economy. Linkages take place when foreign affiliates acquire some parts, components, indirect inputs and services from suppliers in the host economy. This allows the transfer of technology, skills, management experience, and learning through interaction. But in poorer countries where the local enterprise sector is in its earlier stages of development such linkages may not take place automatically. Special policy and regulatory measures may be necessary to upgrade the capability of local suppliers and also to encourage foreign affiliate firms to use local inputs and interact more with local enterprises.

Policies commonly used to encourage linkages include fiscal incentives for enterprises willing to develop local capability to supply foreign affiliate firms; SMEs support programmes; subcontracting exchange schemes; matchmaking programmes; and establishing industrial and technology parks to provide local firms the opportunity to build capabilities through clustering and inter-firm partnerships. An important lesson for poor countries is that strengthening the domestic enterprise sector should be seen as an integral part of an investment strategy aimed at attracting high-quality FDI, promoting linkages, and improving the opportunity for learning and stimulating growth. Equally important is a favourable international policy environment, which preserves the freedom to design appropriate trade and investment policies.

Of course, the effect of linkages on local enterprises depends, among other things, on the quality and types of investment, the range of inputs supplied, the terms of procurement, and the willingness of TNCs to sustain linkages. Large-scale and capital-intensive mining operations, for example, tend to generate limited opportunity for linkages because of the low local capabilities to produce high-quality and specialised mining equipment as well as the know-how that large-scale mining requires to remain competitive. In poor countries, the main local inputs in such operations are the labour force (largely semi-skilled) and a limited amount of services. This is the reason for the "enclave" nature of many foreign mining operations in Africa. They rely on imports for up to 95 percent of their technical inputs, which means that a significant proportion of the foreign exchange earned by the mining companies is used to acquire the input needed to keep them operational and competitive.

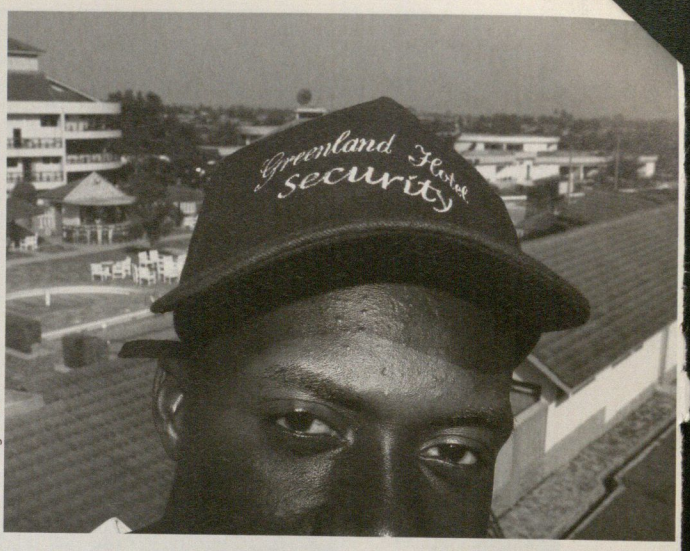


Photo: Ron Giling/Lineair

In contrast, some service activities (e.g. tourism) and assembly or manufacturing activities (e.g. automobiles) tend to generate many linkage opportunities because of the multiplicity of the inputs required. Successful cases of local capability building through linkages to foreign investment in the automobile industry include Thailand, South Africa, Brazil, and Mexico.

Concluding remarks

There is no doubt that, with a focused investment and industrial policy, FDI can play a role in reducing poverty. However, there also may be risks in relying on FDI. For example, FDI activities could create income distortions in the domestic market; perpetuate dependency on foreign technology; contribute to urban unemployment when TNCs disinvest and leave the country in search of lower-cost locations. As argued in this article, poor countries must design investment policies that help them not only to attract FDI but above all to benefit from it to the greatest possible extent.

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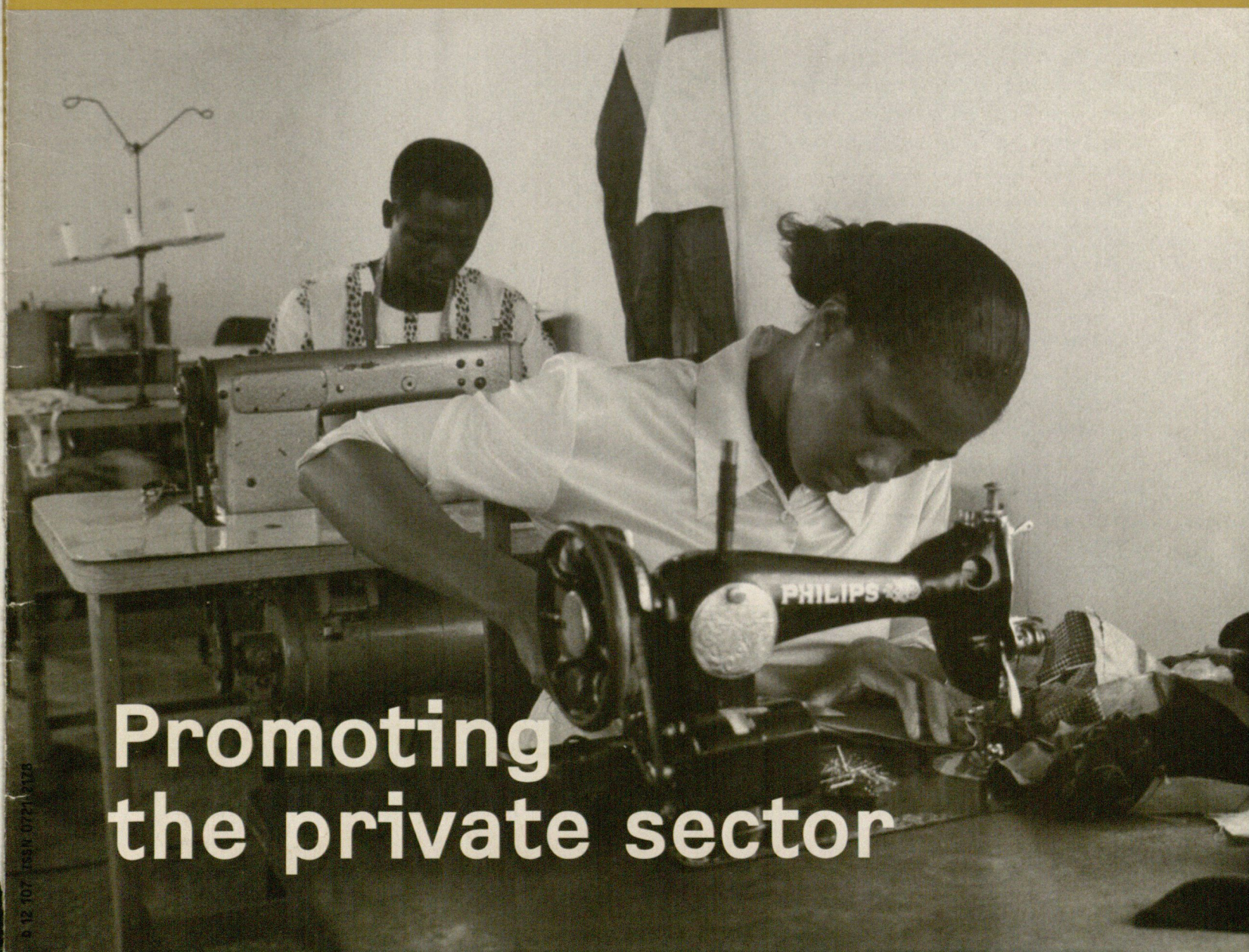

Promoting the private sector

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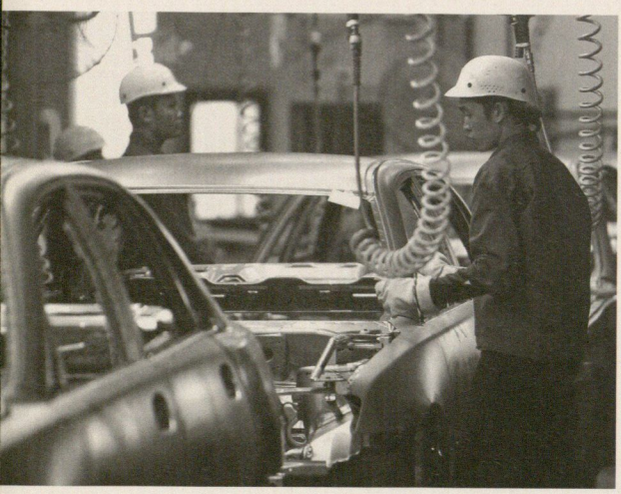

Photo: Ahmad Yusuni/AFP/Getty Images

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Private enterprises drive economic development. Governments must create favourable business environments, promote local businesses, and attract foreign investors. Policy needs to be coordinated with the private sector. It is also crucial to have a vision of the direction in which the economy is to develop.

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The Executive Board voted for him; he himself indicates continuity. However, the op-ed pages of the international press overwhelmingly opposed the idea of making Paul Wolfowitz the next president of the World Bank.

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Countries like China, India or Brazil strongly influence the development of their respective regions. That is why cooperation with them is indispensable.

Front page: *Small garment enterprise in Accra, Ghana. Photo: Tillmann Elliesen*