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# **FDI and development: what is the role of international rules and regulations?**

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Theodore H. Moran \*

The “Doha Development Round” of trade negotiations has opened new debates – and reopened old ones – about the appropriate role of international rules and regulations to govern foreign direct investment. How and when might non-discriminatory and most-favoured-nation treatment be extended to foreign investors? Should the World Trade Organization be used to enforce minimum standards of worker treatment in the plants of international investors and their suppliers? What are the advantages and disadvantages of revising the dispute settlement mechanism of the World Trade Organization on investment issues to replicate the arbitration procedures in bilateral investment treaties? Negotiators who must grapple with these broad questions are not best served by a simple reiteration of assertions about the desirability or undesirability of specific negotiating proposals. Rather, in rethinking possible trade-and-investment negotiations in the aftermath of the collapse at Cancun, they need a fresh effort to synthesize the most recent investigations of how to maximize the benefits – and avoid the dangers – of utilizing foreign direct investment for development. This effort must begin by looking at the latest evidence about the positive – and negative – impact of foreign direct investment on the growth and welfare of host countries in the developing world, with a view to reassessing what policies best serve the interests of the recipient countries. It requires examining how lesser and least developed countries might work their way into the circle of host economies that have successfully used foreign direct investment to enhance their growth, and determining whether they must lower their labour standards to do so. It requires dissecting the controversies surrounding Chapter 11 of the North American Free Trade Area to see what light might be shed on the trade-and-investment agenda in the Doha Round.

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\* Marcus Wallenberg Professor of International Business and Finance, School of Foreign Service, Georgetown University, Washington, D.C., United States. Contact: morant@georgetown.edu. The author wishes to thank two anonymous referees for helpful suggestions in strengthening this article. He remains responsible for what remains.

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**Key words:** foreign direct investment, development, Doha Round, trade-and-investment, transnational corporations, technology transfer

## **Introduction**

To attempt an ambitious – perhaps overly ambitious – synthesis of the role of international rules and regulations in affecting foreign direct investment (FDI) and development, this article is divided into five sections. The first one examines new findings about the relationship between FDI and development – within the growing critique of the old “Washington consensus” and the growing concerns about “globalization” – and explores the opportunities and hazards associated with using FDI for growth.

The following section then asks whether relatively poorer countries are fated to be left outside the ranks of those that can successfully harness FDI for development. It examines whether the same host-country policies – and the same international regulations to govern those policies – serve the interest of developing and least developed countries, or whether developing and least developed countries should be accorded “special and differential” treatment.

But attracting FDI to poor countries is hardly appealing, if it entails grave mistreatment of the workers employed in foreign affiliates. The next section examines whether countries with lowest-skilled workforces must engage in a race-to-the-bottom in labour standards as they try to get launched with exports of labour-intensive products like garments and footwear. It investigates whether poor worker treatment might give host countries an “unfair” advantage in attracting FDI and penetrating export markets for labour-intensive products.

Building on the concerns about least-skilled workers, the subsequent section examines the proposal to use the World Trade Organization (WTO) to enforce compliance with rules ensuring reasonable and acceptable treatment of workers. It contrasts a WTO-based enforcement system with the burgeoning voluntary

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codes of conduct and monitoring arrangements for the affiliates of transnational corporations (TNCs) and their suppliers.

Drawing on the materials in the preceding sections, the following one scrutinizes specific issues included in the Doha trade-and-investment agenda, including non-discrimination and most-favoured-nation (MFN) treatment for investors, dispute settlement and arbitration, compensation, and the right to regulate in the public interest. It examines experiences with Chapter 11 of the North American Free Trade Area (NAFTA) to suggest what might be more advantageous – and less advantageous – modalities for multilateral supervision of investor-host country relations. It concludes with an assessment of what might be most beneficial, and what might most realistically be accomplished, in the Doha Round.

### **FDI and development: the context for designing rules and regulations**

The presumed benefits from globalization – from the growing flows of goods, services, capital, and technology across borders – are being subjected to increasingly critical scrutiny. The “Washington consensus” is being deconstructed and ridiculed.<sup>1</sup>

This article deals with one dimension of globalization: the spread of FDI, as TNCs explore for natural resources, build infrastructure, and establish plants and factories in developing countries. It looks at one element of the “Washington consensus”, the presumption that FDI is an unequivocal good (as long as the investors do not pollute the environment or engage in blatantly harmful treatment of workers), and the more FDI the better.

This article begins with the most basic question: is FDI good – or bad – for development?

The answer is “yes”.

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<sup>1</sup> Stiglitz, 2002.

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A careful assessment of the impact of FDI on the growth and welfare of recipient countries in the developing world does not simply yield “mixed results”. A careful assessment of the impact of FDI on the growth and welfare of recipient countries in the developing world yields – in some cases – very positive results, and – in other cases – very negative results.

What accounts for the difference in outcomes? And what might be the role of international rules and regulations in avoiding the negative outcomes and promoting the positive?<sup>2</sup>

FDI in natural resources – in oil, gas, copper, nickel, bauxite, gold, diamonds, iron ore, and other minerals – can have a dramatic impact on the balance of payments and the tax revenues of the host country where the natural resources are found. The conventional wisdom for decades has been that abundant natural resource endowments that could be exploited by FDI – if TNCs utilized responsible environmental practices – should be considered an unambiguously positive factor in host country development.

Quite at odds with this conventional wisdom, however, has been the discovery that abundant natural resource endowments are – in general – negatively correlated with host-country growth rates (Sachs and Warner, 2001).

One hypothesis for why this is so has been the possibility that the ability to export oil or copper or other minerals leads to an overvalued exchange rate that suppresses the prospects for other competitive local industries; this is the so-called “Dutch disease”.

Other hypotheses, however, focus more directly on the potential for corruption, and for subsidized sweetheart projects generated by the presence of resource revenues: countries become trapped in a game of diverting natural resource rents to

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<sup>2</sup> This article focuses on the economic impact of FDI on host-country growth and welfare. The issue of the impact of FDI on the environment of the host country requires separate treatment.

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political purposes and uneconomic endeavours, instead of providing systematically for broad-based sensible economic initiatives (Ascher, 2000; Ross, 1999). Here the contrast between countries like Nigeria in which oil-based revenues have been a curse for the citizenry at large, and countries like Chile in which copper-based revenues have been a key for positive economic feedbacks across industries and regions within the country, is striking.

Multilateral supervision may have a role to play in limiting corruption and mismanagement of natural resource revenues. One example might be found in Chad, where the World Bank helped broker an agreement involving Exxon Mobil in which the parliament passed a law dedicating 10% of all oil revenues to be held in trust for future generations (Useem, 2002). Eighty per cent would be devoted to education, health, and rural development, and 5% would go directly to the regions where the oil was produced. The expenditure of all revenues would take place under the supervision of a nine-person committee that includes four non-governmental organization (NGO) representatives. Meanwhile, the World Bank would help the Government of Chad create a technically competent financial audit organization.

More broadly, George Soros and a number of NGOs have recommended that all TNCs involved in oil, gas and other natural resource extraction in developing countries be required to make public disclosure of taxes, fees, royalties and other payments to governments as a condition of receiving listing on the United States or other major stock exchanges. This recommendation has a prisoner's dilemma implications for each country and each TNC: all might benefit from a more transparent system, but no country or investor wants to put itself at a competitive disadvantage by providing total transparency if others do not. A multilateral agreement could resolve the dilemma and generate the internationally optimum outcome.

The impact of FDI in infrastructure has likewise traditionally been viewed as providing an indisputably positive contribution to host country development. Efficient and reliable

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water, power, transport, and telecommunication systems boost the welfare of the population and the growth of the economy. Realistic pricing of infrastructure services – in comparison to the more popular but inefficient subsidization of infrastructure services – extends those services to more users, including poor and rural users (Irwin *et al.*, 1997).

A somewhat unanticipated problem with FDI in infrastructure has been that governments and parastatal agencies have made – or have been forced to make, as a condition of receiving the investment – excessive commitments to supply inputs, or to purchase outputs, from infrastructure providers, or to assume foreign-exchange liability for transactions that take place in local currency. The failures of infrastructure projects in Argentina, Brazil and Indonesia – for example – have prompted a reassessment of what constitutes commercial as opposed to political risks, and what the appropriate apportionment of responsibility among public and private actors should be.<sup>3</sup>

This reassessment has led to questioning about the extent to which the International Centre for Settlement of Investment Disputes (ICSID) and the United Nations Commission on International Trade Law (UNCITRAL) arbitration procedures – as called for in most bilateral investment treaties (BITs), and by national investment guarantee agencies (like the Overseas Private Investment Corporation in the United States) and multilateral bank lending agreements – are the appropriate mechanism for dealing with many kinds of contemporary infrastructure investment disputes.

In the MidAmerican case in Indonesia, for example, the Ministry of Finance provided a pledge that it would cause the State-owned oil and gas corporation and State-owned utility to honour take-or-pay power purchase agreements for the foreign affiliate's geothermal projects (Martin and Bracey, 2001). When the contagion from the Asian financial crisis spilled over into Indonesia in 1997, the Government of Indonesia found itself

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<sup>3</sup> Cf. Berry, forthcoming.

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committed to buy power that it did not need and did not have the financial resources to pay for. When Indonesia postponed MidAmerica's projects, MidAmerica pursued its rights under arbitration. In 1999, two consecutive arbitration panels found Indonesia in breach of contract. When the Government did not honour the panel rulings, MidAmerican filed claims for \$290 million with the Overseas Private Investment Corporation (OPIC), leaving it to the latter to pursue salvage with Indonesia.

In this actual case, the Government of Indonesia may have behaved in questionable ways. But the case has raised general questions about whether an international arbitration system that places legal contract compliance requiring a foreign exchange payment to a TNC ahead of all other funding priorities, including importation of food and medical supplies for a population in distress, is a viable model for regulating the activities of even the most honourable host country authorities. These questions will arise again in the discussion on arbitration procedures in international commercial law as a possible integral part of trade-and-investment dispute settlement in the Doha Round.

The most striking new assessment about the impact of FDI on development has come in evaluating the pro's and con's of FDI outside of natural resources and infrastructure.

The "new" discovery is that the impact of FDI in manufacturing, agribusiness, processing, and assembly operations takes two quite distinct forms. The data show that there is a fundamental difference in performance between affiliates that are integrated into the global or regional sourcing networks of the parent TNCs, and affiliates that are oriented towards protected domestic markets and prevented by mandatory joint-venture and domestic-content requirements from being so integrated.<sup>4</sup>

When TNCs build plants upon whose performance their competitive position in international markets depends, they

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<sup>4</sup> For the detailed evidence and background for the examples that follow, see Moran, 2001.

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deliberately capture all economies of scale, and use cutting-edge technology and quality control techniques. They typically insist upon whole or majority ownership, and upon freedom to source from wherever they deem best. General Motors' or Volkswagen's engine plants in Brazil, or Ford's engine plants in Mexico produce products that are perfect substitutes for engines produced in the United States or Europe. Seagate's disk drive plants in Singapore and Thailand and Intel's semiconductor plants in Costa Rica and Malaysia incorporate the most advanced practices in the worldwide industry. From a dynamic perspective, the parent companies upgrade technology and quality control – in their own self-interest – on a continuous near-real time basis.

When TNCs build plants to serve small local protected markets, often with mandatory joint venture partners and designated amounts of domestic content, they use technology that is 3-6 years behind the frontier in the industry in plants that are of boutique size.<sup>5</sup> They show a reluctance to send local managers and technicians to headquarters for training, or to send technical support services from headquarters to the field.<sup>6</sup> The scale of operations is typically too small to permit newest quality control techniques. Mitsubishi and Daewoo's assembly of completely-knocked-down automobile kits in Viet Nam in 1996 took place in joint venture plants one tenth to one twentieth the size of full-scale operations in Japan or the Republic of Korea (Ngo and Conklin, 1996).<sup>7</sup> Hewlett Packard's and Apple's assembly of computers in Mexico (prior to the liberalization of

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<sup>5</sup> On technology sharing, see Mansfield and Romeo, 1980; Lee and Mansfield, 1996.

<sup>6</sup> In 14 industries as diverse as chemicals, medical products, metal products, rubber, food, textiles, transportation equipment, and electrical goods, Vijaya Ramachandran (1993) found that indicators for technology transfer and for the interchange of managers and technicians between parents and affiliates were significantly higher for wholly owned affiliates than for joint venture partnerships or licensees.

<sup>7</sup> It is important to note the difference between TNCs freely choosing a local partner to help penetrate a host country market and TNCs being required to form a joint venture as a condition of entry. TNCs frequently enter a host country via a joint venture, and then shed the local partner when/if they decide to use the host site as an integral part of the parent's regional or global sourcing network.

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the informatics industry) allowed the parent firms to reap a second round of rents from old technology shared with joint venture partners, charging 130-170% of the external price for models three years out of date (Harvard Business School, 1990). For both economic and technological reasons, these kinds of operations can rarely be used as building blocks in an infant-industry or import-substitution strategy for development.

Technology transfer mandates too are counterproductive. Ari Kokko, Magnus Blomström and Mario Zejan (1992) have found that host country demands requiring foreign investors to transfer skills to local personnel, provide access to the parent firms' patents, or perform research and development locally are negatively correlated with technology inflows into the host country.

Not only do mandatory domestic content and joint venture requirements act as a detriment to having the parent TNC integrate the host country plant into the company's supply network and to keeping plant on the frontier of best industry practices, but they also often result in subtracting from host country growth and welfare. A study by Dennis Encarnation and Louis Wells (1986) of 83 investment projects in 30 developing countries over more than ten years demonstrated the dramatic difference between tightly integrated export-oriented plants and non-integrated domestic-oriented plants. Using cost-benefit analysis that evaluated all inputs and outputs to the plants at world market prices, they found that the former generated a substantial increase in host country income, while the latter (from a quarter to almost a half of the sample) actually subtracted from host country income. That is, in the case of the latter, the host country would have been better off without the FDI having taken place at all.

The evidence on backward linkages from affiliates that are integrated into the parent firm's global network, and from affiliates that are prevented by mandatory joint-venture and domestic-content requirements from being so integrated, shows the same bifurcated results.

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Suppliers to foreign affiliates oriented towards protected domestic markets have often not been able to achieve economies of scale for their own operations, nor been able to incorporate the most advanced quality control procedures. Prior to the liberalization of Mexico's informatics regime, indigenous component producers supplying inputs to the joint ventures of Hewlett Packard and Apple utilized hand soldering assembly techniques and old-fashioned casing materials (such as fibreglass). As part of Viet Nam's import substitution regime, indigenous firms helping Mitsubishi and Daewoo meet host-country domestic-content requirements were limited to plastic parts and other simple components that did not have to be mass-produced.

Suppliers to foreign affiliates integrated into the parent firms' supplier networks, in contrast, received instruction in lowest cost production techniques, large batch quality control monitoring and just-in-time delivery. Auto parts producers in Brazil, Mexico and Thailand qualified – under parent firms' supervision – for original equipment manufacturers (OEM) or replacement equipment manufacturers (REM) status (Doner *et al.*, 2002). Electronic component producers in Malaysia and Thailand became contract manufacturers to foreign affiliates, with increasingly intense interaction between engineers from the foreign company and engineers from the local supplier (Lim and Fong, 1991; Rasiah, 1995; Ernst, 1999). To help host country firms achieve economies of scale, the foreign automotive or electronics investors provided export coaching, focusing first on sales to sister affiliates of the investors but leading later to penetration of international markets more broadly.

Developing countries that have been successful in promoting dynamic, competitive backward linkages have done so not by imposing heavy domestic-content requirements on protected foreign affiliates but by helping export-oriented foreign affiliates to identify reliable suppliers, by instructing them in what machinery to purchase, and by loaning them funds to purchase the machinery, with repayment in the form of purchase contracts for the output (UNCTAD, 2001; McKendrick *et al.*, 2000).

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The payoffs for host countries that shape their policies to take advantage of the potent relationship between headquarters and those affiliates upon which the parent firms' international competitive position depends is much greater than conventional measurements have indicated. Traditional models of the contribution of FDI to host country development focus on the investor as a provider of capital. Newer growth theories – in particular, the “endogenous growth theory” – view FDI as providing a package of capital, technology, managerial supervision, quality control procedures, and export channels that enables the host economy not simply to do what its comparative advantage allows it to do more efficiently, but to expand the dimensions of comparative advantage by undertaking entirely new endeavours. In this context, the globalization of industry via FDI provides estimates of the positive impact on host country growth that are *twenty times greater* than the conventional framework suggests (Romer, 1994).

Indeed, when there are economies of scale in TNC production networks across borders, the simultaneous liberalization of trade and investment may produce gains on the order of *twelve times greater* than the outcome when home and host economies are allowed to remain segmented, with almost all of the benefits going to the developing host country (Markusen *et al.*, 1995).<sup>8</sup>

As pointed out, the distinction between the two categories of FDI in manufacturing and assembly – between “good” FDI, and “bad” FDI, so to speak – will be crucial in determining where to start and how to proceed in the trade-and-investment negotiations in the Doha Round. The distinction is an important revision of the “Washington consensus”: the truth is that not all FDI is beneficial for development; some FDI – even FDI with high wages and good environmental practices – has a negative impact on the growth and welfare of the host economy and should be discouraged while the protectionist policies that sustain it are prohibited.

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<sup>8</sup> These results rely upon using a computable general equilibrium model. The home-host pair of economies used for this estimation was the United States and Mexico.

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To ensure that the Doha Round policy debate remains on track, therefore, requires avoiding flawed analytical techniques that have sometimes obscured the difference between the positive and the negative impacts of FDI. Some analysts have simply lumped data from foreign affiliates integrated into the parent TNCs' international sourcing strategy with data from foreign affiliates burdened with mandatory joint venture and domestic content requirements and oriented towards a protected domestic market (Harrison, 1996; Aitken and Harrison, 1999). As can be seen from the preceding analysis, this is like investigating the impact of minerals – in general – on a patient's health, with some dosages containing calcium and iron, and other dosages containing lead and mercury. Medical examiners will discover some strengthening of body functions and some severe disorders derived from the intake of “minerals”, without knowing what to conclude about overall ingestion of minerals. Not surprisingly, a comparable failure to separate out demonstrably favourable FDI from demonstrably unfavourable FDI produces similarly muddled results about the impact on host-country welfare. Some analysts have concluded that there is no “special value” from FDI; but this computation of no “special value” is derived from adding plus \$1 of favourable investment with minus \$1 of unfavourable investment, and making an erroneous assessment that the impact is simply zero (Rodrik, 1999, 2003).

Once the impact of FDI on development is measured properly it becomes clear that mandatory domestic-content, joint-venture and technology-sharing requirements do not, in fact, serve the development interests of host countries. This provides a starting point for assessing possible trade-and-investment negotiations in the Doha Round.

But first it is necessary to investigate whether the same policy measures towards FDI – and the same multilateral restrictions on those policy measures – serve the interests of the developing and least developed countries as they serve the interests of more advanced developing countries.

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## Launching poorer developing countries on FDI-led growth

What do poorer developing countries have to do to break into the ranks of those countries harnessing the beneficial effects of export-oriented investment? Do the same policies that enhance the contribution of FDI to richer developing countries serve the interests of poorer developing countries?

FDI has historically been heavily concentrated in a relatively small handful of developing countries. Over the past decade, ten countries have accounted for 59% and twenty countries have accounted for 72% of all FDI in the developing world (UNCTAD, 2001a). If natural resources and infrastructure are left aside, the figures for FDI in manufacturing and assembly operations are even more concentrated. Recent research has made it fashionable to engage in a kind of geographical or cultural determinism in which some continents or regions – African countries, tropical regions, for example – may be condemned to a future that does not include the potential benefits from FDI.<sup>9</sup>

The evidence shows, however, that the ability of poorer countries to attract significant amounts of FDI in manufacturing and assembly, and to utilize it for development, is by no means impossible, including for poorer countries in Africa and in the tropics.

The case that has become the model for lesser developed countries in launching a successful export-oriented growth strategy via FDI is Mauritius (Phillips *et al.*, 2000). In 1982 a fresh group of political leaders turned away from an import-substitution development strategy, adopted realistic macroeconomic and exchange rate policies, and granted foreign affiliates a liberalized export-processing-zone (EPZ) status – allowing 100% foreign ownership and freedom to source duty-free inputs from around the world – wherever they chose to locate in the island country.

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<sup>9</sup> Sachs, 2001.

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Textile investors – first from Hong Kong (China) and Taiwan Province of China, later from Europe – rendered Mauritius one of the little known export-led success stories. Steven Radelet (1999) has calculated that over a period of more than two decades Mauritius ranked seventh among the fifteen most rapidly growing manufacturing exporters among low and middle income countries around the world – less dramatic than Hong Kong (China), Singapore and Taiwan Province of China, but more impressive than such frequently-cited examples such as Israel, Portugal and Thailand, averaging an average growth rate of almost 3% per year. By 2000, foreign affiliates (and domestic firms that grew up in their shadow whose indigenous management frequently began as employees in the foreign affiliates) produced manufactured goods totalling more than \$1.2 billion annually, employing 80,000-90,000 workers, representing 70% of all exports (IMF, 2001).

Closely paralleling the Mauritius experience is the case of Madagascar, which in 1989 took the decision to liberalize its economy, adopt a realistic exchange rate and rely on foreign affiliates for export-led growth (Razafindrakoto and Roubaud, 1995). With regulations that once again allowed 100% foreign ownership and exclusion from explicit domestic content requirements, the rate for attracting FDI to Madagascar was superior even to that of Mauritius, totalling 120 firms in the first five years for the former in comparison to 100 companies in the first ten years for the latter. By 1998 Madagascar had 158 firms in its EPZs, with exports of \$195 million and employment of more than 36,000 workers (EIU, 2000, reference table 12).

The outcomes in Mauritius and Madagascar are clearly replicable among other poorer developing countries. Other countries that have followed the same modest agenda of macro, micro and institutional reform – providing relatively low inflation and competitive exchange rates, rewarding investment and entrepreneurship, and assuring reasonably reliable commercial law protections – include El Salvador, Honduras, Lesotho, Nicaragua and Uganda. All of these countries have turned away from import-substitution development strategies and allowed foreign affiliates to operate without performance

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requirements such as domestic contents, joint ventures or technology-sharing mandates. They have not had to achieve perfection in their domestic economic conditions in order to be successful. Their common discovery is that a country does not have to rise to the top rankings of “business climate” by *International Country Risk Guide*, *Institutional Investors Ratings*, *Competitiveness Indicators of the World Economic Forum*, and *Transparency International* in order to launch FDI-led growth with exports in the hundreds of millions of dollars and employment in the tens – if not hundreds – of thousand workers. In popular jargon, a would-be host country does not have to “become like Denmark” in order to attract and utilize FDI for development.

Meanwhile both Mauritius and Madagascar – but especially Mauritius – began to move from least-skilled FDI to slightly higher-skilled foreign-affiliate operations, and to build backward linkages that created greater value-added in the host economy. After gaining experience in foreign affiliates, host-country managers and supervisors used the accumulated skills to set up their own companies. Mauritius reduced the burden of regulation required to set up local firms and reduced taxes, from 35% to 15%, on manufacturers who did not qualify for the EPZ tax exemption. Some entrepreneurs became suppliers to foreign-affiliate exporters; other began to enter export markets. In the late 1990s, indigenous investors accounted for 50% of all equity capital in the export community (EIU, 2000, reference table 12). The activities of the exporters moved from low-end textiles and footwear to include light industry, sports equipment, agribusiness, and cut flowers, as well as higher-end garments such as shirting for Marks and Spencer.

The next step might be found in countries like the Dominican Republic and the Philippines (Rhee *et al.*, 1990). Concurrent with liberalizing trade and investment, the central Governments in Manila and Santo Domingo replaced investment screening boards oriented towards imposing performance requirements on foreign investors with investment promotion boards aimed at actively courting TNCs, speeding regulatory approvals and providing a one-stop-shop to facilitate their entry

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into the host economy. Both countries allowed private developers from the Europe, Japan and United States to take over management of EPZs and industrial parks, relying on the developers' self interest to round up new investors in increasingly more sophisticated industries. FDI in electronics, plastics, auto parts, and industrial equipment gained in prominence alongside textiles, shoes and toys. The Dominican Republic and the Philippines then turned their attention towards Costa Rica and Thailand for examples of how to attract FDI in the computer, telecommunications, medical equipment, machine tool, semiconductor, and data processing industries, and how to utilize "vendor development" programmes to create local contract manufacturers and OEM suppliers for the foreign-affiliate exporters.

In this sequence of harnessing FDI for development, the same ingredients that have helped the more advanced developed countries have served the interests of developing countries. In fact there is a progression in which El Salvador and Uganda, for example, can replicate the progress of Mauritius and Madagascar, while the latter replicate the progress of the Dominican Republic and the Philippines, while the latter replicate the progress of Costa Rica and Thailand, while the latter replicate the progress of Ireland and Singapore – each step including ever greater degrees of trade-and-investment liberalization for domestic firms as well as foreign affiliates.

These findings will prove indispensable when addressing the contention repeatedly expressed in the WTO Working Group on Trade and Investment that developing and least developed countries require different and more protective policy measures than developed countries as they attempt to generate domestic growth.

Before examining the agenda of the WTO Working Group on Trade and Investment, however, there is a separate set of issues that requires careful scrutiny, namely, that host countries might have to permit poor treatment of workers in order to attract FDI in low-skill labour-intensive operations like garments and footwear; and that host countries that do permit poor treatment

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of workers gain an “unfair advantage” in penetrating international markets. These are the subject of the following section. This in turn sets the stage for examining the debate about whether WTO should be used to enforce minimum standards of worker treatment.

### **Race-to-the bottom dynamics in the treatment of workers in low-skilled labour exports**

Many developing countries have expressed concern that starting along the path of FDI-led growth with low-skill labour-intensive products like garments and footwear will expose them to race-to-the-bottom pressures on worker treatment in their economies. Many developed countries – led by trade unions and their political supporters in the United States – have expressed concern that substandard treatment of workers has given developing countries an unfair advantage in attracting FDI and penetrating international markets for labour-intensive products.

To what extent do host countries have to tolerate substandard treatment of workers in order to be successful in attracting FDI and penetrating international markets for low-skill labour-intensive products? What indications are there that poor worker treatment offers host countries in the developing world an unfair advantage in attracting FDI or penetrating international markets for labour-intensive products?

Looking back over the past two or three decades, there is indisputable evidence that some TNCs (and their home governments) have demanded that host countries adopt weak labour policies as a condition for receiving inward FDI. Namibia and Zimbabwe, for example, reported to the International Labour Organization (ILO) that they were being warned in the mid-1990s that their EPZs would have to be excluded from coverage by national labour laws in order to attract FDI (ILO, 1996). Pakistan likewise told the ILO that pressure from Daewoo had led them to exempt their EPZs from full applicability of national labour law (Elliott, 2000). Acting on behalf of their TNCs, the Ambassadors from Japan and the Republic of Korea were

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reported to have insisted that Bangladesh refuse to let trade unions be organized in the country's EPZs, an action that was narrowly diverted by threats of the United States to withdraw the Generalized System of Preferences (GSP) if the Government complied.<sup>10</sup>

The history of workers losing their jobs while trying to organize unions in EPZs – or being arrested, or murdered – is atrocious (ILO, 1998a).

At the same time, however, the general proposition that weak labour standards help attract FDI is not supported by the data. Mita Aggarwal (1995) of the United States International Trade Commission could find no correlation between measures of poor enforcement of labour standards and levels of United States FDI in ten developing economies (China, Hong Kong (China), India, Indonesia, Malaysia, Mexico, the Philippines, Singapore, Republic of Korea and Thailand). Quite the opposite: United States TNCs tended to favour investing in countries with higher labour standards, and in industries in which worker treatment was superior to – or at least equal to – conditions prevailing in the rest of the economy.

Similarly, Dani Rodrik (1996) failed to find any statistical relationship between low labour standards and levels of United States FDI in a study of 36 developed and developing countries. On the contrary, the evidence indicated that nations with low labour standards received lower amounts of FDI than would be predicted on the basis of other host country attributes. These results, concluded Rodrik, “indicate that low labour standards may be a hindrance, rather than an attraction, for foreign investors” (*op. cit.*, p. 57).

Nor does the evidence suggest that poor treatment of workers provides an “unfair” competitive advantage in penetrating international markets for labour-intensive products like garments and footwear.

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<sup>10</sup> EIU, 2001, p. 19. Bangladesh is now in the midst of a five-year phase-in of trade unions in the country's EPZs.

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Investigation at the firm level can measure the extent to which a supplier that squeezes the unit labour cost of a particular product by (for example) reducing wages, withholding benefits, forcing unpaid overtime, or lowering health and safety standards might gain a competitive edge against products produced under more satisfactory working conditions.

Data on unbranded jeans produced in Nicaragua, gathered by the United States National Labor Committee in 2000, showed that the piecework rate to sewers was \$0.66 for a pair that retailed at Kohl's in the United States for \$21.99 (National Labor Committee, 2002a). The unit labour cost thus equalled approximately 3% of the final sales price, and a hypothetical squeezing of expenditures on worker treatment by one-third would lower production costs by \$0.22 per pair of jeans.

Data on footwear produced in Indonesia, gathered by the Clean Clothes Campaign, showed that local production costs for \$100 athletic shoes were 2% of the retail price, with the unit wage element 0.4% or \$0.40 (Clean Clothes Campaign, 2002). Once again a hypothetical squeezing of worker expenditures by one-third would lower production costs by \$0.13 per pair of shoes.

Data on a blazer produced in China for Spiegel, gathered by the National Labor Committee in 2000, found that the unit labour cost amounted to 0.8% of the retail price of \$99 (National Labor Committee, 2002b). As before, a hypothetical squeezing of worker expenditures by one-third would lower production costs by \$0.28 for each blazer.

At the same time, the profit margin of the suppliers of jeans, footwear, and garments is quite sensitive to these same unit labour costs; the unit labour cost may range from half (for jeans) to one-and-a-half times (for athletic shoes) the unit profit received by the producer. Thus the data suggest that subcontractors on the competitive fringe may well squeeze workers in unfair and intolerable ways to augment their earnings, but the data do not show that compression of expenditures on workers offers much margin for competitive advantage in boosting exports from countries that permit such compression.

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This conclusion is reinforced by aggregate studies of export performance. The Organisation for Economic Co-operation and Development (OECD), for example, examined the prices of textile products imported from developing countries and found that these prices were “rather uniform” despite a wide variation in worker treatment (OECD, 1996). In another test, the OECD separated developing countries according to their adherence to freedom of association and right to collective bargaining and tracked changes in the countries’ share of exports in world markets. The study could find no relationship between observance of these core labour standards and the penetration of international markets.

This conclusion is supported by the investigations of Aggarwal (1995) cited earlier: countries with lower labour standards did not show higher rates of import penetration into the United States, for example, than countries with higher labour standards. Instead, Aggarwal found that those countries with strongest export performance enjoyed rates of increase in average real wages comparable to, or faster than, the rate at which real value was added. In short, export success and better worker treatment advanced in parallel.<sup>11</sup>

Thus, just as low labour standards do not offer an unfair advantage in attracting FDI, low labour standards do not appear to enhance significantly the competitiveness of exports.

Pointing in the opposite direction, the ILO offers reports that superior worker treatment – including more adequate wages and benefits, team-work production methods, access to on-the-job training and promotion – enhances productivity and reduces turnover (ILO, 1998b, p. 8). On a more systematic basis, the ILO has found, in regular surveys, that worker compensation in EPZs is consistently higher than elsewhere in the economy (ILO,

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<sup>11</sup> After controlling for productivity differences and various measures of civil rights, political rights, democratic institutions, and unionization in 36 developed and developing countries, Rodrik (1996) found that the only statistically significant relationship was between longer statutory hours and enhanced comparative advantage in textiles and clothing.

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1998a). Data from the United States Department of Labor show that firms in the footwear and apparel industries generally pay more than the minimum wage and provide working conditions superior to those that prevail in other labour-intensive industries (USDL-BILA, 2000).

Other studies provide evidence that workers in export-oriented foreign-affiliates receive higher pay and benefits, and have better working conditions, than comparable workers in other industries. In neither Mauritius, nor Madagascar, for example, was domestic economic success built on the backs of workers exploited by foreign affiliates or domestic firms. In both countries the workforce in the EPZs received wages and benefits superior not just to alternative employment in agriculture but also to equivalent employment throughout the economy. Holding education level, extent of professional experience and length of tenure in the enterprise constant, Mireille Razafindrakoto and Francois Roubaud (1995) found that EPZ workers in Madagascar earn 15-20% more than other workers in the country (*op. cit.*, pp. 233-234). Overall, in Mauritius, real wages within the EPZ manufacturing sector rose by more than 50% between the late 1980s (Romer, 1992) and the late 1990s.

Higher wages and benefits for workers in foreign affiliates are not limited to more advanced developing countries. Compensation for host-country workers in foreign manufacturing affiliates, as calculated by Edward M. Graham, is in fact greater as a multiple of average compensation per worker in the manufacturing sector for low-income and least developed countries than for middle-income developing countries. In middle-income developing countries, local workers in foreign affiliates earn 1.8 times the average manufacturing compensation; in low-income and least developed countries, local workers in foreign affiliates earn 2.0 times the average manufacturing compensation.<sup>12</sup>

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<sup>12</sup> Graham, 2000, table 4-2, pp. 93-94. Graham eliminates salaries for foreign managers and supervisors from these calculations.

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In recent years, the idea that FDI-export-led growth is incompatible with allowing workers the option of organizing trade unions has also proved to be invalid. To be sure, most foreign affiliates have preferred to operate without unions. But the possibilities for union organizing have expanded substantially in many countries.

The Philippines, for example, was well known for repression of union organization in low-wage, low-skill EPZs – such as the Bataan EPZ – in the 1970s and early 1980s (ILO, 1998a, pp. 23-24). By the 1990s, however, with freedom of association recognized and enforced by law in the zones, some of the EPZs with least skilled workers have had successful union-organizing drives (in Bataan one third of the firms operate with union contracts); other EPZs with a larger proportion of higher skilled workers in semiconductor and auto parts plants, such as the Cavite and Baguio City zones, have had elections in which workers rejected the option of forming unions.

Similarly, prior to 1992, the EPZs in the Dominican Republic were exempted from national legislation permitting freedom of association and right to collective bargaining (ibid.). With the assistance of the ILO, in 1992, the Dominican Republic drafted labour legislation that extended freedom of association and right to collective bargaining throughout the economy. As in the case of the Philippines, workers in firms devoted to lower skilled operations in the Dominican EPZs sometimes voted for unions; in firms devoted to higher skilled plants in the Dominican EPZs they often did not.

Overall, the idea of trying to use a large unskilled labour pool with low wages and no employment alternatives to attract FDI has given way to a recognition that investment promotion has been far more successful in countries and in regions where educational institutions produce a literate, semi-skilled and trainable workforce. In Costa Rica, the Dominican Republic and the Philippines, vigorous secondary education and vocational training programmes have had a high payoff in pulling in FDI in industries like electronics, auto parts, medical equipment, and

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data processing, alongside more traditional garment and footwear producers. The same has been true of Mexico.

In the Philippines, Texas Instruments pioneered the establishment of the Baguio City industrial park where the more than 63% of male and 66% of female employees had some post-secondary education. In the Dominican Republic, Westinghouse played the role of zone owner as well as exporter in setting up the San Isidro EPZ near a relatively high-skill labour pool. In Costa Rica, Intel worked with local technical high school teachers and professors from the Institute of Technology to design special one- and two-year vocational training programmes for potential semiconductor assembly employees, before committing to build a \$300 million facility. In Mexico, the State of Baja California has relied on a growing reputation for skill-training of the workforce to attract auto parts producers (Toyota) and aircraft parts producers (Pratt & Whitney) as lower-cost *maquiladora* jobs moved to China (Lindquist, 2002). The city of Guadalajara, meanwhile, has utilized nine well-regarded universities and technical institutes to create a mini-Silicon Valley with Hewlett Packard, 3Com and Intel (Linguist, 2000).

The movement towards slightly more skill-intensive products in turn has a dramatic impact on ensuring more favourable worker treatment. Foreign affiliates whose output is required to meet sophisticated standards of quality and reliability in international markets discover that their own self-interest requires them to take measures to attract and retain superior workers.<sup>13</sup> Wages and benefits are two-to-five times higher than for footwear or garment workers. The work environment often includes day care, healthcare, on-the-job training, and night classes(Rhee *et al.*, 1990).

When foreign affiliates producing more skill-intensive products are established in proximity to foreign affiliates and domestic-owned plants producing less skill-intensive products, the managers of the former begin to pressure the managers of the latter to improve labour standards across the board. Costa

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<sup>13</sup> This hypothesis is tested in Elliott, 2000. The findings are positive.

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Rica, the Dominican Republic and the Philippines witnessed a broad process of *institutional change* in worker-management relations across EPZs and industrial parks, led by the foreign affiliates in the more advanced industries (Elliott, 2000). Texas Instruments, Westinghouse and Intel – all cited earlier – were instrumental in this process. The attraction of greater numbers of FDI projects, and more sophisticated FDI, has proven to be a powerful force for improving labour standards in host economies. The increasing globalization of manufacturing from least-skilled to higher-skilled industries has pulled host countries up towards better worker treatment, not down towards inferior worker treatment.

### **WTO-based enforcement of rules on worker treatment vs. voluntary codes of conduct and monitoring mechanisms**

The evidence in the previous section indicates that there is no pressing need to find some mechanism to protect firms and workers in the developed countries against the “unfair” use of low labour standards to attract FDI or to penetrate international markets (Elliott, 2000). But what about the larger argument about using the WTO to ensure compliance with core labour standards, in general? What are the pro’s and con’s of trying to use the WTO to enforce rules and regulations about the treatment of workers? How might a more aggressive use of voluntary codes of conduct for TNCs, backed by transparent independent monitoring, compare to a WTO-based system?

The evidence introduced in preceding sections reveals that there are hidden dangers in a prospective WTO-based enforcement system. An enforcement system built around the WTO would allow a member State to file a complaint against another State for an alleged violation, or “pattern of violations”, of a given set of core labour standards, leading to an investigation and dispute settlement procedure. If the investigation confirmed the violation or pattern of violations, and the dispute settlement failed to rectify the matter, the country bringing the complaint would be allowed to suspend its WTO obligations and retaliate against the offending State (blocking imports or demanding a fine).

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The ILO “core labour standards” are freedom of association and effective recognition of the right to collective bargaining, abolition of the worst forms of child labour, elimination of forced or compulsory labour, and elimination of discrimination in respect of employment and occupation. The violation or pattern of violation would not necessarily involve TNCs – the offending actions could take place anywhere in the target economy – but TNCs would inevitably be drawn centrally since they are likely to be among the exporters or purchasers of exports where retaliation is likely to occur.

Herein lies the principal peril inherent in a WTO-based system of retaliation. If retaliation (blocked imports or a meaningful fine) were limited to the plant where the labour violations took place, the result would be to “punish the victim” since the abused workers would likely find their plant closed or themselves laid off. If the retaliation were spread across all plants in the same industry (say, all footwear plants), the result would be “collective guilt” that punished those with exemplary labour standards as well as those without. Labour standards violations by an athletic shoe supplier in the Bataan EPZ in the Philippines could result in penalties that stopped exports from the Reebok plant in that EPZ awarded a nation-wide prize for the treatment of workers (ILO, 1998a, pp. 23-24). In addition, another of the side effects would be to undermine the ability of TNCs to assure their subcontractors that adherence to model labour practices will lead to reliable purchase contracts.

If the retaliation were spread across plants in diverse industries, with TNC electronics and auto parts exporters having to atone for the sins of subcontractors in the garment industry – as is current practice in United States GSP retaliations – the result would be to block the one sure path leading from least desirable worker treatment to superior treatment of workers in the host economy. Leaders in the establishment of progressive worker-management relations – like Texas Instruments in the Philippines, Westinghouse in the Dominican Republic, and Intel in Costa Rica – would find their output placed at risk as punishment for the practices of non-OECD suppliers to the college sweatshirt industry.

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The broader the scope of retaliation, moreover, the greater the danger that a hypothetical WTO-based system would be captured by protectionist interests in the developed world. The argument is sometimes made that the potential for capture is low because OECD countries no longer produce many of the labour-intensive products in industries in which labour violations might be found: retaliation would simply shift the locus of production among less virtuous and more virtuous developing-country sites. But if imports of machine tools, auto parts, electrical equipment, and medical devices could be blocked to enforce observance of core labour standards in production of toys and jewellery, this system suddenly would offer a lucrative target for capture by industrial producers in the developed countries.

Does this mean that no international pressures are needed to help improve worker treatment around the world?

An increasingly powerful alternative to a WTO-based system is the expansion of so-called “voluntary” measures to hold TNC investors and retailers responsible for decent treatment of workers in their own plants and throughout their supply chains. The past decade has seen the proliferation of codes of conduct for TNCs. Sometimes their adoption has been accompanied by passion and commitment on the part of senior management. Sometimes their adoption has been accompanied by cynical disinterest on the part of senior management. But they provide a lever for outside observers – investors, financial institutions, civil society groups – to demand to know how the codes are being implemented, what procedures are in place for monitoring compliance, and how the corporation responds to complaints and violations. For TNCs that spend millions of dollars on image and reputation – including reputation for corporate social responsibility – the downside risk of bad publicity is not trivial. “Voluntary” compliance has become more than voluntary.

The initial impulse of most TNCs however has been to keep channels for monitoring compliance under rather tight control, utilizing monitors (such as auditing firms) who are

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dependent upon company headquarters for other lucrative business, and refusing to divulge the location of their plants or the results of monitoring investigations. Once again the pressure from civil society – including, notably, university groups whose logo was attached to garments and sportswear – has loosened the mechanisms of control. In 2003 the Fair Labor Association, one of the most prominent corporate compliance organizations in the United States, for example, joined the Workers Rights Consortium in agreeing to publicize the monitoring results and remediation procedures when violations were found. The trend line is towards enabling independent, objective assessment of results by all interested parties.

There has been a simultaneous shift from simply cutting off contracts to suppliers guilty of poor worker treatment to a commitment on the part of international buyers and TNCs to try to work with offenders to bring worker treatment up to acceptable levels. Here the vast disparity between unit labour costs, recorded earlier, and the final retail price again becomes important: international buyers and TNCs have oligopoly rents, image-advertising budgets, corporate responsibility accounts to absorb that small extra marginal cost of ensuring compliance throughout their supply chains. They also have first hand experience for use in training suppliers how to maximize productivity and minimize turnover in labour-intensive production operations.

The potential for expanding the “voluntary” system of rules and regulations to promote satisfactory worker treatment remains substantial. The Ethical Trading Initiative estimates that as many of 85% of all large United States and Canadian TNCs operate with some kind of social responsibility guidelines, with United Kingdom TNCs somewhat less.<sup>14</sup> In France, however, an OECD survey (Gordon and Miyake, 2000, p. 24) found that eight of nine branded apparel firms were unaware of apparel-industry codes and had “no plans to work on one”. In the same survey Japanese TNCs reported that they had not experienced any social pressure to respond to concerns about labour standards in their

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<sup>14</sup> See [www.ethicaltrade.org](http://www.ethicaltrade.org).

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supplier chains. In the same vein, the Global Reporting Initiative – an organization supported by the United Nations to promote social audits, like financial audits, among TNCs – has yet to reach levels of transparency about monitoring results and remediation efforts associated with the Fair Labor Association and the Workers Rights Consortium. The large international retailers – like Walmart and Target – lag far behind “best practices” for reporting in the industry, as represented by Nike, Levi Strauss and Gap.

The commitments specified in codes of conduct of leading TNCs and compliance organizations moreover are remarkably specific, in contrast to the unsettled and controversial interpretations that surround ILO core labour standards. Levi Strauss’ Terms of Engagement specify: “We respect workers’ rights to form and join organizations of their choice and to bargain collectively. We expect our suppliers to respect the right to free association and the right to organize and bargain collectively without unlawful interference”.<sup>15</sup> Mattel Global Manufacturing Principles assert: “We refuse to conduct business with any manufacturer or supplier who discriminates either in hiring or in employment practices”.<sup>16</sup> The Fair Labor Association’s Workplace Code of Conduct stipulates: “Every employee shall be treated with respect and dignity. No employee shall be subject to any physical, sexual, psychological or verbal harassment or abuse”.<sup>17</sup> The Levi Strauss Terms of Engagement mandate that “...workers can be no less than 15 years of age and not younger than the compulsory age to be in school. We will not utilize partners who use child labor in any of their facilities”.<sup>18</sup> The Nike Code of Conduct requires that every supplier “...agrees to submit to labor practices audits or inspections with or without prior notice”.<sup>19</sup>

It is quite likely that voluntary commitments like these can be used to promote decent treatment of workers more rapidly and more effectively than trying to develop a detailed

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<sup>15</sup> [www.levistrauss.com](http://www.levistrauss.com) (March 2003).

<sup>16</sup> [www.mattel.com](http://www.mattel.com) (March 2003).

<sup>17</sup> [www.lchr.org/sweatshop/amendedFLA](http://www.lchr.org/sweatshop/amendedFLA) (March 2003).

<sup>18</sup> [www.levistrauss.com](http://www.levistrauss.com) (March 2003).

<sup>19</sup> [www.nikebiz.com/labor/code](http://www.nikebiz.com/labor/code) (March 2003).

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jurisprudence that WTO dispute settlement panels could follow to determine guilt or innocence with regard to compliance with ILO core labour standards.

Are countries in compliance with freedom of association and right to collective bargaining if:

- they exclude agricultural workers, migrant workers, or domestic workers from collective bargaining? (The ILO says no; many countries including the United States, say yes.)
- they require a majority of workers involved to authorize a strike? (The ILO says no; many countries, including the United States, say yes.)
- they allow employers to hire permanent replacements for striking workers, and permit those replacement workers to vote in a decertification election to eliminate union recognition? (The United States, along with Burkina Faso, Cape Verde, the Central African Republic, Djibouti, Madagascar, and Niger say yes; the ILO is ambiguous; see ILO, 2000, p. 38.)

Multilateral agreement on how to instruct WTO dispute settlement panels on these questions is certain to be contentious, and whatever outcome might be achievable will almost surely require many countries – not least the United States – to change national and state labour law.

Are countries in compliance with effective abolition of child labour if:

- they allow families (including young children) to work together to harvest coffee or bananas?
- they fail to provide education of quality and accessibility to all children below the age of 15?
- they do not succeed in monitoring domestic and informal sector employment?

Multilateral agreement on how to instruct WTO dispute settlement panels on these questions will have to differentiate intent from capability, and determine whether trade law violations be adjusted to reflect the degree of development of

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the offending country. The difficulties of constructing a WTO jurisprudence for trade-and-labour-standards cases reinforces the earlier scepticism about using the WTO to punish poor worker treatment, and reinforces the appeal of pushing for more extensive and more vigorous voluntary efforts instead.

### **The agenda of trade and investment issues in the Doha Declaration**

The possible enforcement of labour standards within the WTO was not included in the part of the Doha Declaration dealing with trade and investment issues (paragraph 22). Nor has this subject been part of the agenda of the WTO Working Group on the Relationship between Trade and Investment.

Turning to some of the most important issues that have been identified in the Doha Declaration for possible multilateral negotiation despite the breakdown of negotiations at Cancun, what are implications of the preceding analysis for “development provisions”; “modalities for pre-establishment commitments based on a GATS-type, positive list approach”; “non-discrimination;” “consultation and the settle of disputes between members”; and “right to regulate in the public interest”?<sup>20</sup> Where might the expansion of rules and regulations governing FDI be easiest and most desirable, and where hardest and most fraught with danger? What perspective might a multilateral agreement in which rules and regulations governing FDI have been most extensive – namely, Chapter 11 of NAFTA – provide for upcoming negotiations?

The launch of trade negotiations at Doha in 2001 acquired the label of being a “Development Round”. But some important submissions to the WTO Working Group on the Relationship between Trade and Investment dealing with “development provisions” suggest that the outcome might be just the opposite (WTO, 2002).

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<sup>20</sup> This section draws on Moran, 2003. The complete list on the agenda for possible trade and investment negotiations in the Doha Round also includes scope and definition; transparency; and exceptions and balance-of-payments safeguards.

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To understand why requires going back to the principal accomplishment on trade-and-investment in the Uruguay Round, the Agreement on Trade-related Investment Measures (TRIMs). The TRIMs Agreement requires all WTO members to eliminate domestic-content requirements and import-export balancing requirements placed upon foreign affiliates. (The TRIMs Agreement did not cover mandatory joint venture or technology sharing requirements.) Developed countries had a two-year time limit to phase out these requirements. Developing countries had a five-year time limit. Least developed countries had a seven-year time limit. Several countries have petitioned for extensions of the phase-out period, including Chile, Malaysia, the Philippines, Romania and Thailand. The WTO Council on Trade in Goods has approved these petitions in return for a specific schedule for removing the requirements.

Far from endorsing the accomplishment of the TRIMs Agreement – or recognizing the harmful impact of domestic content requirements of host country growth and welfare – the discussions of trade and investment at Doha and the subsequent deliberations of the WTO Working Group on the Relationship between Trade and Investment clearly indicate that some developing country members want to reopen, and roll back, the TRIMs Agreement. One country contends that domestic-content requirements are an “extremely useful and necessary tool” in promoting host country development.<sup>21</sup> Another country endorses “measures to encourage the use of products of domestic origin, which plays an important role in the process of improving the industrial base of developing countries and the ensuing generation of income, employment, and balance of payments equilibrium”.<sup>22</sup> The list of objectives proposed for the Working Group to pursue include “imposition of manufacturing requirements on foreign investors, protection of domestic producers, use of binding obligations on technology transfer, and avoiding crowding out of domestic firms”.<sup>23</sup>

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<sup>21</sup> Reported in UNCTAD, 2001b, pp. 64-65.

<sup>22</sup> Reported in UNCTAD, 2001b, p. 69.

<sup>23</sup> Reported in WTO, 2002. Some submissions to the Working Group also assert that joint-venture requirements encourage indigenization, and technology-sharing requirements augment the transfer of technology.

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These contentions are quite at odds with the findings reported in this article. The evidence reviewed there provides a rather clear assessment that any movement in this direction would not serve the interests of the developing world. This article points out moreover that there is no reason to propose that investment policies that benefit richer developing countries are not appropriate for poorer developing countries.

Indeed, rather than re-legitimizing the use of domestic-content requirements, the evidence suggests that interests of both richer and poorer developing countries would be served best by *expanding* the TRIMs Agreement to proscribe mandatory joint-venture and technology-sharing requirements as well. Across the developing world, the elimination of mandatory joint-venture and technology-sharing requirements would lead to larger flows of cutting edge technology, management and quality control procedures into host economies.

The empirical observation that enlarging, rather than scaling-back, the TRIMs Agreement would enhance the prospects for development sets the stage for a fresh assessment of the “modalities for pre-establishment commitments based on a GATS-type, positive list approach” from the agenda of the WTO Working Group on the Relationships between Trade and Investment. “Pre-establishment commitments” refer to the decision of a host country to grant right of establishment on non-discriminatory MFN terms to foreign investors.

The “positive list approach” specifies those industries for which the commitment to grant right of establishment on non-discriminator MFN terms is offered, along the lines of the General Agreement on Trade in Services (GATS), with all other industries reserved for possible exclusion or denial of national or MFN treatment. Many developing countries favour this approach, arguing that this gives them more flexibility in implementing their development strategies. This was the format incorporated in the Japan-Republic of Korea BIT and the Japan-Singapore Economic Partnership Agreement. This “positive list approach” is contrasted to the “negative list approach”, in which

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there is a specification of those industries for which the commitment is not made, implying that the commitment exists for all other unspecified industries. Many developed countries – led by the United States – favour this approach, arguing that this leads to greater investment liberalization. This was the mode of treating trade and investment in NAFTA Chapter 11.

But if developing countries were to recognize that a promise to end the domestic-content, joint-venture and technology-sharing performance requirements would enhance their own self-interest in incorporating into their host economies foreign affiliates that form an integral part of the parent firms' supplier networks, as demonstrated above, then the debate about whether and how to accord greater non-discriminatory and MFN treatment to foreign investors might be easier to resolve than is commonly supposed. The imposition of performance requirements constitutes the most common form of discriminatory or non-MFN treatment; the elimination of these kinds of performance requirements opens the door to equal treatment for all firms in those industries for which the host country decides to liberalize investment. If domestic-content, joint-venture and technology-sharing requirements are eliminated as tools of public policy, moreover, the difference between the “positive list” and the “negative list” approaches may end up being not so great in practice.

More difficult than deciding whether to have a “positive” or a “negative” list, or what industries to include or exclude, however, is likely to be the determination of what actually constitutes discriminatory or non-MFN treatment. This has proved quite contentious in the experience of NAFTA Chapter 11.<sup>24</sup>

Over the past two decades, authorities in both developed and developing countries have assumed increasingly broad responsibilities to regulate in the public interest, especially in the area of environmental policy and health and human safety.

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<sup>24</sup> Many of the controversial issues that have arisen with NAFTA Chapter 11 also caused prior difficulties in the failed effort to negotiate a Multilateral Agreement on Investment at the OECD; see Graham, 2000.

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They often pursue these responsibilities by progressively tightening the standards for private-sector activities, while “grand-fathering” existing operations. But – as critics of NAFTA Chapter 11 have pointed out – the ability to hold each generation of investors to meeting higher standards than the previous one might be inconsistent with an agreement to provide non-discriminatory MFN treatment. Environmental regulators need the freedom to oblige newer firms (perhaps foreign affiliates) to meet higher standards than older (perhaps domestic) firms; they must be permitted to deny investors (including foreign investors) the right to operate if they propose to duplicate the performance of others already in business.

Environmental regulators also need flexibility in determining what constitutes “like circumstances”; they must be permitted to treat a foreign-affiliate factory in a precarious watershed differently from a domestic-owned factory located where there is abundant water to absorb organic effluents; they may need to require a foreign affiliate with no other assets in the country to post a bond for potential environmental damage while leaving a domestic company with extensive fixed assets free from this requirement (Mann and von Moltke, 2001a and b).

Equally contentious has been the issue of how to go about “consultation and the settlement of disputes between members”. International business groups have expressed a strong desire to fashion dispute settlement procedures on trade and investment issues in the WTO along lines laid out in NAFTA Chapter 11 and adopted in most BITs.

Under current WTO dispute settlement procedures, the judgment that a member State is in violation of its WTO obligation leads to an order to bring that State’s behaviour into compliance, looking forward. NAFTA Chapter 11 and most BITs, in contrast, utilize international commercial law dispute settlement procedures as developed by ICSID, the ICSID Additional Facility and UNCITRAL. Here a negative judgment grants retrospective relief; that is, a negative judgment awards compensation to make the investor “whole” for past mistreatment.

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Retrospective compensation is directly linked to “right to regulate in the public interest”. While signatories to NAFTA and to BITs cannot be required to change domestic environmental, health, safety or other regulations directly, the requirement to pay compensation could have a constraining effect on the passage of host-country legislation. This depends upon what kinds of measures might be defined as constituting “expropriation” and what level of compensation might be required.

There are three types of expropriation laid out in NAFTA: direct expropriation, indirect expropriation and measures tantamount to expropriation. The latter two encompass host country actions that do not take possession of investor property directly but constitute “interference” with the use of property that deprives the owner of economic benefit. Subsequent disputes among the NAFTA members have focused on whether a given government regulation must inflict a substantial loss upon a foreign investor – as opposed to merely diminishing its profitability – in order to qualify as an expropriatory act, and on whether foreign investors can sue for compensation even when a host country issues a uniform regulation applicable to all firms within its economy.

The level of compensation is also unsettled among the NAFTA signatories. Canada, for example, permits rather broad exercise of police powers (good faith measures to protect health, safety and the environment) without defining these as constituting confiscation or expropriation. The constitutional protection of private property in the United States, however, permits various interpretations, including the requirement in some cases to indemnify the owner for accumulated profits lost over the lifetime of a property affected by a regulation (Van der Walt, 1997; Rose-Ackerman, 1992; Rose-Ackerman and Rossi, 2000). The determination of what constitutes a regulatory “taking”, and what payment might be required to make a foreign investor “whole”, is sure to be a critical component of any trade-and-investment negotiations that might emerge in the Doha Round.

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The desire of international business groups to base dispute settlement in WTO trade and investment cases on NAFTA Chapter 11 has also raised the spectre of affording foreign affiliates greater rights than domestic firms. International dispute settlement procedures could require that a foreign investor pursue remedies in the local legal system, and exhaust all domestic appeals options, before filing a notice of intent to seek external arbitration.<sup>25</sup> But many foreign investors have asserted that the rationale for a new trade and investment regime derives from the desire to avoid getting mired down in slow and potentially biased local court systems. With NAFTA Chapter 11 as a model, therefore, they have proposed that foreign investors should enjoy the option of skipping host country courts and proceeding directly to international dispute settlement (USBRT, 2003). The inevitable result is that foreign investors are afforded greater procedural rights and opportunities than comparable domestic investors, and that host country courts – including host country Supreme Courts – can find their rulings overturned by external dispute settlement panels.

The prospect that TNCs could bring cases against States outside their national courts directly before an international arbitral tribunal, and win, has “come as a surprise” to developed-country policy analysts (Dumberry, 2001). This possibility is not news to developing countries. Under the terms of BITs, and of MIGA or OPIC investment agreements, developing countries have regularly been the target of TNCs before ICSID or UNCITRAL.<sup>26</sup> Developed countries have not often enjoyed this experience.

“Part of the furor arises because states that have traditionally been claimants are now defendants. Most BITs were

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<sup>25</sup> This is the approach of OPIC, for example: investors who have purchased political risk insurance must complete the local appeal process before they can proceed to international arbitration.

<sup>26</sup> The weight of analytical opinion may be swinging, however, in the direction of recommending that multilateral banks and guarantee agencies reassess whether the use of commercial law arbitral panels to decide whether host authorities are committing expropriatory acts constitutes a fitting approach to determining when host authorities are behaving appropriately in the public interest (Berry, forthcoming).

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concluded with developing countries that have very little investment either in the US or in Canada. All of a sudden, from the perspective of the US NAFTA says you can be a defendant. The US can be a defendant”, observes Daniel Price, the principal United States negotiator of NAFTA Chapter 11, “My only advice is, get over it. It is true” (Price, 2001, p. 4).

The reliance on external dispute settlement panels in NAFTA Chapter 11 and BITs have also raised questions about transparency, about expertise and about the precedence of commercial law over broader determinations of what constitutes appropriate public policy. Under ICSID and UNCITRAL procedures, once a complaint is lodged each side chooses an arbitrator and then the parties together appoint a third arbitrator. The presentation of briefs and oral arguments is closed to the public; sometimes so too is the very existence of the case. The outcome of the arbitration may or may not be kept confidential. The arbitrators may be individuals of high legal repute on commercial law matters, but they are not chosen for their expertise on health and safety, environmental or economic policy. The arbitration panels carefully avoid passing judgment on whether the outcomes serve the public interests of the countries involved or of the international community at large. This dispute settlement mechanism may act as the supreme “rule of law” in international commercial affairs, but the result in no sense resembles an international Supreme Court that determines what serves the common good, with transparent procedures open to all those who may be affected.

Thus any attempt to push trade and investment negotiations in the Doha Round in the direction of NAFTA Chapter 11 will encounter a rather long list of weighty concerns about commercial law dispute settlement procedures, expropriatory acts, compensation and the ability to regulate in the public interest, greater rights for foreign investors than for domestic firms, transparency, expertise, and the supranational authority of arbitral panels.

But these concerns need not eliminate all hope for progress in trade-and-investment negotiations in the in the post-Cancun

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phase of the Doha Round. As a primary objective, the most basic, beneficial and doable outcome for trade-and-investment negotiations in the Doha Round would be reaffirmation of the ban on domestic-content and trade-balancing requirements in the TRIMs Agreement, perhaps adding prohibitions on joint venture and technology-sharing requirements as well.

As a more ambitious objective, the next most beneficial and perhaps doable outcome would be an effort to formulate a GATS-like arrangement to extend non-discriminatory and MFN treatment to foreign investors, using a positive or a negative list, backed by current WTO dispute settlement procedures.

More expansive still – but also more problematic – would be to incorporate commercial law arbitration as embodied in NAFTA Chapter 11 and the BITs into WTO dispute settlement procedures for trade-and-investment cases. As indicated above, how to construct such a system so that it clearly serves the interests of developed or developing countries is very much an open question.

Would such an effort be worthwhile? To what extent might success in such an endeavour greatly expand access to FDI for countries that signed on to the agreement? As indicated earlier, the key ingredients in attracting FDI involve macro reform, micro reform and institutional reform, backed by pro-active investment promotion efforts – enough to start some momentum in improving the business climate in the host country.

How much additional investment might result from signing on to a new WTO dispute settlement agreement, along the lines of BIT procedures? The evidence of strong additional investment attraction is not apparent in the data derived from the decision to adopt a BIT itself. The United Nations Conference on Trade and Investment (UNCTAD, 1998) found little indication that BITs, for example, increased flows of FDI. The UNCTAD research examined a single year of investments and tested whether the number of BITs signed by the host was correlated with the amount of FDI it received.

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The 2003 *Global Economic Prospects* of the World Bank reports the results of a substantial retest of the evidence in 2002 by Hallward Driemeier (World Bank, 2003, p. 129). Driemeier expanded the investigation to 20 years of data, looking at the bilateral flows of OECD members to 31 developing countries. The analysis found that countries that had concluded a BIT were no more likely to receive additional FDI than were countries without such a pact. The study then examined whether a BIT might act as a signalling device that would draw attention to a particular location, thereby leading to an increase in flows in the aftermath of negotiations. But when flows in the three years after a BIT were signed were compared to flows in the three years before, there was no significant increase in FDI. Finally, the study investigated whether the presence of a BIT affected the relative amount of FDI that a given source country allocated to a particular host. Once again there was no statistically significant correlation.

When added to the problematic aspects of trying to construct any trade-and-investment regime along the lines of NAFTA Chapter 11, this has extremely cautionary implications for the Doha Round negotiations. Without a large payoff from the more elaborate commercial law-based structure promising to emerge as an outcome, the Doha Round negotiators may want to focus their attention on trying to achieve solid but modest progress on trade and investment issues, limiting themselves to some combination of the first two objectives outlined above. ■

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# FDI in India

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V.N. Balasubramanyam and Vidya Mahambare \*

This article analyzes the determinants of foreign direct investment and its efficacy in promoting development in India. It examines the reasons for the relatively low volumes of foreign direct investment in India. It argues that the volume of foreign direct investment a country is able to attract is a function of its structure, stage of development, sources of foreign direct investment it has access to and the volume of cooperating factors it possesses. The article also argues that although foreign direct investment is a superb catalyst of development, large volumes of it alone may be ineffective in promoting growth in the absence of preconditions necessary for efficient operations of foreign affiliates. For these and other reasons, discussed in the article, exhortations that India should throw open all doors to foreign direct investment may be misplaced. And China, which has attracted relatively large volumes of foreign direct investment, may not be a role model for India.

**Key words:** foreign direct investment, economic liberalization, India

## Introduction

There has been a considerable change in policies and attitudes towards foreign direct investment (FDI) on the part of most developing countries in recent years. Distrust and suspicion of FDI in the past appears to have yielded place to a newfound faith in its ability to foster growth and development. This change in attitudes is due to a number of factors: a steep reduction in alternative sources of finance such as bank credit in the wake of the debt crisis, the demonstrable success of the East Asian countries based in part on FDI, and growth in knowledge and

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\* The authors are, respectively, Professor of Development Economics, International Business Research Group, Department of Economics, Lancaster University, Lancaster, United Kingdom, and Research Fellow, Cardiff Business School, Cardiff University, Cardiff, United Kingdom. Contact: v.balasubramanyam@lancaster.ac.uk.

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understanding of the nature and operations of transnational corporations (TNCs), the principal purveyors of FDI.

In 1991, India too liberalized its highly regulated FDI regime, in place for more than three decades. Arguably it took an economic crisis for India to liberalize its trade and FDI regime rather than a fundamental change in attitude towards the role of FDI in the development process. Nonetheless, the 1991 reforms marked a major break from the earlier dirigiste regime with its regulation of the spheres of foreign affiliate participation and its modes of operation. And the policy framework was opaque with the implementation of policies towards FDI based on bureaucratic consideration of each case on its merits.

The 1991 economic reforms were to change all this. Along with the virtual abolition of the industrial licensing system, controls over foreign trade and FDI were considerably relaxed, including the removal of ceilings on equity ownership by TNCs. The reforms did result in increased inflows of FDI during the decade of the 1990s. Even so, the volume of FDI in India is relatively low compared with that in most other developing countries. The relatively low volume of FDI in India, especially so in comparison with that in China, has attracted widespread comment. If China, with its newfound faith in capitalism, can embrace and attract substantial volumes of FDI, why can't India, which is blessed with western institutions and capitalist organizations? Those who advocate that India should attract increased volumes of FDI argue that "in terms of foreign investment, it is the direct investment that should be actively sought for and doors should be thrown wide open to FDI. FDI brings huge advantages (new capital, technology, managerial expertise, and access to foreign markets) with little or no downside" (Bajpai and Sachs, 2000, p. 1). Admittedly FDI is a potent instrument of development. But sweeping generalizations such as FDI brings huge advantages, it has no downsides and throwing doors wide open would necessarily attract increased volumes of FDI are suspect.

The case for attracting large volumes of FDI into India requires an analysis of the determinants and impact of FDI in the Indian context. Why has the liberalization of the FDI regime

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failed to attract increased flows? Does China's experience with FDI provide any lessons for India? Would increased volumes of FDI alone necessarily accelerate growth and development? This article addresses these and other issues drawing upon the literature on FDI in general and on FDI in India in particular. It reviews the determinants of FDI, analyzes the efficacy of FDI in promoting development, examines policies, and draws conclusions for policy makers.

## **Determinants**

Why do firms go abroad? Why do they choose to invest in specific locations? The literature on these issues emphasizes three main elements, which guide the FDI decision process of TNCs. John Dunning (1973) neatly synthesizes these elements in the well-known eclectic paradigm or the OLI explanation of FDI. For a TNC to invest successfully abroad it must possess advantages which no other firm possesses (O), the country it wishes to invest in should offer location advantages (L), and it must be capable of internalizing operations (I). Internalization is synonymous with the ability of firms to exercise control over operations essential for the exploitation of ownership and location advantages.

It is location advantages that form the core of much of the discussion on the determinants of FDI in developing countries. The two other attributes necessary for FDI are taken as given from the perspective of developing countries. Dunning's (1973, 1981) analysis set in train a number of econometric studies designed to identify the main determinants of FDI (Agarwal, 1980; Root and Ahmed, 1979; Levis, 1979; Balasubramanyam and Salisu, 1991). The main conclusions of these studies can be briefly summarized as follows:

- Host countries with sizeable domestic markets, measured by gross domestic product (GDP) per capita and sustained growth, measured by growth rates of GDP, attract relatively large volumes of FDI.
- Resource endowments of host countries, including natural resources and human resources are a factor of importance in the investment decision process of TNCs.

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- Infrastructure facilities (including transportation and communication networks) are an important determinant of FDI.
  - Macroeconomic stability, signified by stable exchange rates and low rates of inflation, is a significant factor in the FDI decisions of TNCs.
  - Political stability in the host countries is a significant factor in the investment decision process of TNCs.
  - A stable and transparent policy framework towards FDI is attractive to potential investors.
  - TNCs place a premium on a distortion free economic and business environment. An allied proposition here is that a distortion free foreign trade regime, which is neutral in terms of the incentives it provides for import substituting and export industries, attracts relatively large volumes of FDI than either an import substituting or an export-promoting regime.
  - Fiscal and monetary incentives in the form of tax concessions do play a role in attracting FDI, but these are of little significance in the absence of a stable economic environment.

India fares well on the attributes relating to market size and growth. Its growth rate of around 6% per annum since the 1990s is substantial if not dramatic. India's overall record on macroeconomic stability, save for the crisis years of the late 1980s, is superior to that of most other developing countries. And judged by the criterion of the stability of policies it has displayed a relatively high degree of political stability.

It is, however, India's trade and FDI regimes that are major impediments to increased FDI inflows. Admittedly, the 1991 reforms considerably relaxed the dirigiste regime, which prevailed for more than four decades. Even so, the product and factor market distortions generated by the earlier policy regime continue to persist. And liberalization of the economy has not progressed much since the 1991 reforms. Also there seems to be a wide gap between intent and practice of policies towards FDI.

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### *The pre-1991 phase*

Two distinct phases can be identified in India's foreign trade and FDI regimes: the pre-1991 reforms phase and the post-1991 phase. The pre-1991 phase, which stretches over four decades, is well worth reviewing in some detail for two reasons. First, although the regime was marked by extensive regulation of trade and investment, it did not shun FDI participation in the economy. Second, the pattern and industrial composition of FDI it gave rise to seems to have endured and may be a factor in the volume and pattern of FDI in India in recent years.

The cumbersome and complex nature of the regulatory framework during those years has been extensively analyzed (Kidron, 1965; Kumar, 1994). The policy framework specified industries in which both foreign financial and technical participation were allowed, those in which only technical collaboration was permitted, and those in which neither technical nor financial participation was allowed. This sort of a selective approach governing the degree of foreign participation in industry reflects the desire to delimit foreign ownership and control to industries of the economy in which its contribution was deemed to be essential. A preference for technical collaboration agreements as opposed to foreign equity ownership appears to have been dictated by the desire to promote the twin objectives of preserving freedom from foreign control over operations and at the same time gaining access to foreign technology and know-how. There were though bouts of liberalization, as in the mid-1950s and the 1980s, mostly though not entirely dictated by foreign-exchange shortages. The growth in the number of foreign collaboration agreements approved over the years (table 1) and foreign equity participation in Indian industry reflect these swings in policy.

India's reputation for hostility towards FDI though is mostly due to the restrictions on equity participation and export obligations imposed during the 1970s. The Foreign Exchange Regulation Act (FERA) of 1973 was Prime Minister Indira Gandhi's response to the economic crisis that bedevilled most years of her premiership. Her economic policy initiatives were

mostly driven by political exigencies rather than an objective strategy with specific goals. Hostility to private enterprise, especially foreign affiliates, headline-grabbing initiatives such as the nationalization of banks along with increased state control of economic activity were all part of an orchestrated strategy to please the electorate. The FERA required foreign affiliates to dilute their equity holdings to less than 40% or export a substantial share of their total output. In response to these regulations some TNCs such as IBM and Coca Cola chose to close down their operations in India, some fell in step with the requirement that foreign affiliates should shed equity in favour of Indian nationals, others such as Unilever diversified their production base in order to fulfil export obligations stipulated by the FERA in return for retaining majority equity ownership. During the period of 1967-1979, the number of collaboration agreements per year reached an all-time low of 242, and the proportion of agreements with foreign equity participation fell from 36% during the years 1959-1966 to 16% over the years 1967-1979 (Kumar, 1994). During the twelve-year period of 1967-1979 the total value of foreign capital approved by the Government amounted to only \$0.6 billion and the net inflow (net of dividends and repatriation of capital) was negative (Lall and Mohammad, 1983).

**Table 1. Foreign collaboration approvals in India, 1948-2003**

Period	Number of collaborations	Those with foreign equity		Foreign investment (Rs billion)
		Number	% in total	
1948-1958	500	..	..	..
1959-1966	2 079	756 <sup>a</sup>	36	..
1967-1979	2 904	468	16	0.6
1980-1990	6 587	1 554	24	10
1991-1995	8 137	4 183	51	594
1996-2000	10 782	7 867	73	1 873
2001	2 270	1 982	87	269
2002	2 273	1 966	86	114
Jan-Apr 2003	580	467	81	12

*Sources:* Calculated from Kumar, 1994, table 1.4, and India, SIA, 2003.

<sup>a</sup> 1961-1966.

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The mid-1980s saw a considerable though not a radical relaxation of the dirigiste trade and investment regime, with a relatively benign attitude towards foreign affiliates. Prime Minister Rajeev Gandhi, with his penchant for science and technology, mirroring that of his grandfather Nehru, appeared to have been much more sanguine about foreign affiliates' presence in the economy than his predecessor. The total number of collaboration agreements approved per year increased from 242 during the period of 1967-1979 to 658 during the period of 1980-1990.

One of the major consequences of the policy regime during the pre-1991 phase was a significant change in the pattern of FDI in India, away from plantations, minerals and petroleum, towards the manufacturing sector. By the end of the 1980s manufacturing accounted for nearly 85% out of a total stock of FDI around rupees (Rs) 28 billion. Within the manufacturing sector, the high technology-intensive industries such as machinery and machine tools, transport equipment, electrical equipment and chemicals including pharmaceuticals accounted for the bulk of FDI (table 2).

Although there are a number of estimates of foreign presence in Indian industry, they differ from each other depending on data and concepts they employ. Nagesh Kumar (1994) estimated that, at the end of the 1980s, the share of foreign affiliates in the assets or sales of the organized private corporate sector in India was around 23%. The share of foreign affiliates in individual industries, within the manufacturing sector, however, varied widely, from a high of 98% in leather products to a low of 7% in textile machinery. In the case of 11 industries, including processed foods, cigarettes, leather goods, pharmaceuticals and automotive components, the share of foreign affiliates in total sales exceeded 66%; in 15 others – including electrical lamps, electric machinery, paints and varnishes and automobile components – the share of foreign affiliates in total sales ranged between 34 and 66%. More recent estimates (Athreye and Kapur, 2001) suggest that over the period of 1970-1994 foreign affiliates accounted for between a third and a quarter of gross sales of India's manufacturing sector.

These estimates, especially those relating to individual industries, suggest that foreign control over Indian industry during the pre 1991 phase was not low; in fact, it was significant in a number of consumer goods and technologically intensive industries. Whilst the regulatory phase may have limited the absolute volume of FDI in India relative to that in some of the Latin American and East Asian countries, it may not have limited the extent of control exercised by foreign affiliates in individual industries and the manufacturing sector in general.

The size of markets in India, especially for consumer goods with well known brand names, India's industrialization policies with emphasis on science and technology oriented industries,

**Table 2. Sectoral distribution of the inward FDI stock in India, 1964-2003**

(Rs billion and percentages to total)

Industry	March 1964		March 1974		March 1980		March 1990		Approvals August 1991 –April 2003	
	Value	%	Value	%	Value	%	Value	%	Value	%
<b>I. Plantations</b>	<b>1.1</b>	<b>19</b>	<b>1.1</b>	<b>12</b>	<b>0.4</b>	<b>4</b>	<b>2.6</b>	<b>10</b>	<b>n.a.</b>	<b>n.a.</b>
<b>II. Mining</b>	<b>0.1</b>	<b>1</b>	<b>0.1</b>	<b>1</b>	<b>0.1</b>	<b>1</b>	<b>0.1</b>	<b>0.3</b>	<b>43</b>	<b>2</b>
<b>III. Petroleum</b>	<b>1.4</b>	<b>25</b>	<b>1.4</b>	<b>15</b>	<b>0.4</b>	<b>4</b>	<b>0.0</b>	<b>0</b>	<b>775</b>	<b>27</b>
<b>IV. Manufacturing</b>	<b>2</b>	<b>41</b>	<b>6.3</b>	<b>68</b>	<b>8</b>	<b>87</b>	<b>23</b>	<b>85</b>	<b>1 780</b>	<b>62</b>
Food and beverages	0.3	13.2	0.5	8.3	0.4	5	1.6	7.0	98	3.4
Textiles	0.2	7.2	0.4	5.7	0.3	4	0.9	4.0	35	1.2
Machinery and machine tools	0.2	6.8	0.4	6.7	0.7	9	3.5	15.4	55	1.9
Transport and transport equipment	0.2	6.5	0.3	5.1	0.5	6.3	3	12.3	212	7.5
Metal and metal products	0.3	14.4	1	14	1.2	14.6	1.4	6	112	4.0
Electrical equipment and communication (incl. of software)	0.2	8	0.7	11	1.0	12	3.0	13	846	30.0
Chemicals and allied products	0.6	26.2	2.0	32.6	3.0	37.2	7.7	33.4	113	3.7
Miscellaneous	0.4	17.6	1.1	16.7	1.0	12.3	2.0	8.8	309.2	10.8
<b>V. Services</b>	<b>1</b>	<b>14</b>	<b>0.4</b>	<b>4</b>	<b>0.4</b>	<b>4</b>	<b>1.4</b>	<b>5</b>	<b>262</b>	<b>9</b>
<b>Total</b>	<b>6</b>	<b>100</b>	<b>9</b>	<b>100</b>	<b>9</b>	<b>100</b>	<b>27</b>	<b>100</b>	<b>2 859</b>	<b>100</b>

*Sources* Kumar, 1994, India, SIA, 2003.

*Note:* Figures may not exactly add up due to rounding.

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the generally stable macroeconomic environment, and India's endowments of human capital were all factors in the volume and pattern of FDI and technology licensing agreements in the economy during the period of 1950-1990. And foreign presence in a wide variety of industries appears to have been sizeable despite the complex regulations.

This pattern of FDI in India does not appear to have changed during the post-1991 phase. All this suggests that the attraction of India for TNCs resides in the profitable domestic markets for branded goods and high-technology products and India's endowments of human capital, especially its trained scientists and engineers.

### *The post-1991 phase*

The relaxation of controls over FDI constituted a significant element of the wide-ranging economic reforms introduced in 1991. The three main elements of the reform were the abolition of the licensing requirements governing domestic investment, a reduction in tariffs on imports and the relaxation of controls over FDI. The principal changes in the FDI regime included automatic approval of FDI up to 51% of equity ownership by TNCs in a group of 34 technology-intensive industries, a case-by-case consideration of applications for foreign equity ownership up to 75% in 9 industries (mostly relating to infrastructure), and the streamlining of procedures relating to approval of investment applications.

The relaxation of controls over the extent of foreign ownership of equity signalled a major departure from the earlier regime, although foreign ownership of equity over and above 50% was subject to the requirement that the investors should balance all outgoings of foreign exchange on account of their operations with export earnings over a seven-year period.<sup>1</sup> The reform package in general heralded a departure from the earlier dirigiste regime. And FDI flows appear to have responded to the new initiatives: FDI approvals increased from around Rs 10

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<sup>1</sup> These export-balancing requirements have been relaxed in recent years.

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billion (around \$384 million) during the late-1980s to around Rs 2.5 trillion (\$3 billion) during the late 1990s (table 1).

Even so, the volume of FDI relative to the size of the economy is low, accounting for only 5% of gross domestic capital formation. Actual inflows are much lower than approvals (around 21% of approvals amounting to \$54 million between the years 1991-1998), and the volume of FDI India has attracted shades into insignificance compared with the sizeable volume of FDI China has attracted in recent years (table 3). Comparisons between India and China seem irresistible, mostly because of their size, their geographical location and their economic liberalization policies. An analysis of the comparative experience of India and China in relation to FDI may therefore be instructive for policy formulation.

**Table 3. Realized FDI in China and India, 1979-2002**  
(Billion dollars)

Year	China	India
1979-1990	20.6	1.5
1991	4.4	0.1
1992	11.0	0.1
1993	27.5	0.3
1994	33.8	0.6
1995	73.3	1.3
1996	41.7	2.1
1997	45.3	2.8
1998	45.5	3.6
1999	40.4	2.5
2000	40.8	2.2
2001	46.9	2.3 <sup>a</sup>
2002	52.7	3.9 <sup>a</sup>

*Sources:* The US-China Business Council (2003); World Bank database, for India in 1979-1990, World Bank Economic Survey 01/02 for 1991 onwards.

*Note:* Fiscal year for India is from April to March.

<sup>a</sup> While FDI statistics in China, as per the IMF definition, include equity capital, reinvested earnings and other capital (inter-corporate debt transaction between related entities), Indian data include only equity capital. Recent Reserve Bank of India data (RBI, 2003), revised to reflect the international definition, estimates that FDI in India was \$4 billion and \$6 billion in 2001 and 2002, respectively.

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## *FDI in India and China*

Is it likely that China's FDI policy framework is much more liberal than that of India and hence the large volumes of FDI it attracts? In fact, India's FDI regime may be much more liberal than that of China. It is reported that China does not allow wholly owned foreign affiliates in 31 industries and in 31 others Chinese partners are required to hold majority of the equity (Nagaraj, 2003). India's regime allows 51% of equity participation by foreign affiliates with automatic approval and in several industries such as airports and mass transport systems, foreign affiliates are allowed to hold 100% of the equity (WTO, 2002). According to official sources, these and other measures designed to streamline FDI approval procedures place India's FDI policy framework amongst the most liberal regimes (WTO, 2002).

The reasons for India's poor performance in attracting FDI relative to that of China may have to be sought elsewhere other than in its policy framework. These have to do principally with the differing sources of FDI in the two countries, differences in the implementation of policies as opposed to the policy framework in place and the differing composition of FDI in the two countries.<sup>2</sup>

A large proportion of FDI in China, around 40% of the total annual inflows of around \$46 billion are on account of investments from its Diaspora, chiefly from those resident in East Asian economies including Hong Kong (China). There are several reasons for the high proportion of FDI in China by its Diaspora. First, is their familiarity with the culture, institutions and business practices in China. Second, faced with increasing wage costs in East Asian economies such as Taiwan Province of

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<sup>2</sup> It is frequently argued that inflows of FDI into China are overstated because of accounting procedures that differ from those of India and also because FDI in China includes the so-called round tripping variety of FDI flows with capital taken out of China and brought back into the country to take advantage of tax and tariff concessions accorded to foreign investors. Whilst these factors may account for some of the FDI in China they cannot account for the huge differences in the volume of FDI in the two countries.

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China and Malaysia, ethnic Chinese businesses in these countries have sought relatively low wage-cost locations in China.

But India too has its Diaspora, why have they not sought to invest in India? The differing composition of the ethnic Chinese and Indian Diasporas provides one reason for the differences in the volume of FDI from them. Although there are no precise data on the exact size and composition of the ethnic Chinese and Indian Diaspora, evidence suggests that, whilst the Indian Diaspora is located mostly in the United States, the United Kingdom and other western countries, the Chinese Diaspora is mostly located in East Asia. And while the Indian Diaspora, especially so in the United States, mostly belongs to such professions as education, health services, science and engineering, the Chinese Diaspora is much more business oriented. The opening up of China to trade and FDI appears to have provided the Chinese Diaspora an opportunity to extend and or shift its business interests to China and take advantage of relatively low cost labour and land in China. The Indian Diaspora with its lack of business interests has for long opted for the portfolio variety of investment, principally bank deposits. The sudden withdrawal of such investments was one of the proximate causes for the economic crisis India experienced in 1991.

The one notable exception here is the participation of India's Diaspora in the Silicon Valley and the spectacular growth of India's export-oriented software industry. The Indian software engineers and entrepreneurs in the Silicon Valley appear to have successfully utilized India's endowments of highly trained but relatively cheap engineering talent (Balasubramanyam and Balasubramanyam, 2000).

Another explanation for the differing volumes of FDI in India and China relates to the composition of FDI in the two countries. A substantial proportion of FDI in India is located in the high-technology end of the spectrum of industries and in services, whereas FDI in China is mostly located in the low-technology end of the spectrum including electronics, which mostly relates to assembly operations (table 4).

This fact too reflects the differences in the stage of industrialization and local market conditions in the two countries. The relatively high volume of FDI in the technologically oriented industries in India reflects the attraction of a sheltered domestic market for the products of these industries, a consequence of the import-substituting industrialization strategy the country followed for more than four decades. So too is the sizeable presence of foreign affiliates in branded consumer goods (including food products). Most of the consumer goods, even after the 1991 reforms, enjoy not only protection from import competition, but also access to imports

**Table 4. Composition of FDI in manufacturing in China and India, various years**  
(Per cent)

Industry	China FDI stock, 1995	India FDI flows, August 1991-April 2003
<b>Low-technology intensive industries</b>		
Food and beverages	10.5	5.5
Textiles	8.9	2.0
Garments and footwear	6.0	..
Paper and paper products, printing	4.7	2.0
Leather and related products	3.6	0.3
<b>Sub-total</b>	<b>33.7</b>	<b>10.0</b>
<b>High-technology intensive industries</b>		
Chemical and chemical products <sup>a</sup>	3.4	9.0
Rubber products	1.8	0.8
Plastic products	5.1	n.a.
Non metal mineral products	7.7	n.a.
Metal and metal products	5.5	6.3
Machinery manufacturing	4.0	3.0
Special purpose equipment	1.9	0.2
Transport equipment	5.9	12.0
Electrical equipment and machinery	6.6	14.0
Electronics and communication	9.6	33.5
Instruments	1.8	0.1
Other manufacturing		11.0
<b>Sub-total</b>	<b>47.3</b>	<b>90.0</b>

Sources: Huang, 2002; India, SIA, 2003.

<sup>a</sup> including pharmaceuticals. Data on the sectoral distribution of FDI in China are not available for more recent years.

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of equipment at relatively low rates of tariffs resulting in high rates of effective protection. Foreign affiliates facing a liberalized FDI regime have taken advantage of these high rates of protection and the sizeable domestic market for these goods. The total volume of such tariff jumping domestic market oriented FDI would be relatively low for a variety of reasons. These include the product and factor market distortions typical of an import substituting industrialization strategy, the artificial nature of incentives provided by the strategy and the capital and technology intensive nature of such investments. (Balasubramanyam, Sapsford and Salisu, 1996) In contrast, the total volume of export oriented investments designed to exploit cheap labour, as in the case of China, tend to be sizeable.

It is also conceivable that India may not need the sort of FDI that is attracted to low wage and low skill intensive export-oriented industries. Indigenous entrepreneurs, with long years of experience with industrialization and a history of exporting labour intensive products (such as textiles and clothing) may be able to exploit export opportunities in low wage and low skill intensive products. India's overall policy framework, however, appears to dissuade and constrain them from doing so. It dissuades them because of the distinct anti-export bias of India's trade policies which has not been entirely eliminated by the 1991 reforms (WTO, 2002). Average levels of tariffs on imports at around 32% continue to be high, much higher than those in other developing countries such as Indonesia (8.8%), Malaysia (10.2%), Thailand (17%) and the Philippines (9.7%). Tariffs on imports of capital goods and intermediates are low relative to those on final goods, thereby providing high effective rates of protection for the final goods manufacturing industries. The protection afforded to domestic-market oriented industries by these and other policies dissuades investors from investing in export-oriented industries. There are also policies that constrain firms from investing in labour-intensive industries. These include the policy that reserves production of a vast array of labour-intensive products to small scale industries, and labour laws in the organized sector that limit the ability of firms to hire and shed labour in response to market conditions. These laws serve to increase wage costs and provide an incentive for firms to substitute capital for labour.

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Also relevant in this context is the thesis that the relatively large volumes of FDI in China are a consequence of China's policy framework, which discriminates against domestic firms and favours foreign affiliates in the provision of fiscal and monetary incentives (Huang, 2002). The suggestion here is that FDI may be no more than a substitute for domestic investment, which is denied the sort of incentives foreign affiliates enjoy. In the case of India the rules and regulations relating to labour laws and reservation of industries to small-scale industries apply to both foreign affiliates and domestic firms. As a consequence, both sorts of firms appear to have been deterred from exploiting the vast export potential that India's endowments of low skill and low wage labour provides. And both types of investors appear to have opted for the relatively capital-intensive high-technology industries mostly oriented towards the protected domestic markets. As suggested earlier, for various reasons, FDI in these protected industries tends to be relatively low. It is though likely that, if India were to remove the various product and labour market distortions, both foreign affiliates and locally owned firms would invest in labour intensive export oriented industries. And locally owned firms may be able to compete effectively with foreign affiliates in these industries and India may not be compelled to woo foreign affiliates into these industries.

For all these reasons China may not be a role model for FDI in India. The structure, stage of development, sources of FDI and historical factors set India apart from China. The optimum level of FDI a country should aspire for is a function of the structure, stage of development, sources of FDI it has access to and the volume of co-operant factors it possess. For these reasons, econometric exercises (Wei, 1999) that regress current FDI flows into specific countries on variables such as growth rates, per capita incomes and corruption indices and suggest that, let alone India, not even China has fully exploited its potential for inward FDI seem vacuous. These sorts of exercises make little sense because they fail to recognize the interdependence between FDI and growth, they ignore the composition and quality of FDI countries are able to attract, their stage of development, the cooperant factors they are endowed with, and above all they rely on dubious estimates of levels of corruption.

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In sum, India has the potential for attracting increased volumes of FDI. It can do so with a set of policies that are in the interests of not only foreign affiliates but also domestic investors. It is though a bit far fetched to argue that FDI is a panacea for the development problem and India should throw all doors wide open to FDI. It would also be a folly to woo FDI only because China attracts relatively high volumes of FDI.

## **Efficacy**

The one principal characteristic of FDI that distinguishes it from other sorts of capital flows is its ability to transmit technology and know-how, broadly defined to include managerial and marketing know-how. Apart from employment and foreign exchange earnings, FDI promotes technology spillovers that constitute the major contribution of FDI to development.

There are several channels through which such spillovers occur. These include imitation, acquisition of skills, competition and enhanced export intensity of locally owned firms (Gorg and Greenaway, 2001). Imitation of the products produced by foreign affiliates through reverse engineering, an activity that enables local firms to copy the processes and design of new products, is a recognized channel for spillovers. The acquisition of skills occurs mainly through the movement of skilled labour employed by foreign affiliates to locally owned firms. Such internal migration of labour, trained by foreign affiliates, is a significant channel for spillovers. Labour employed in foreign affiliates may wish to set up their own establishments with the experience and skills gained from their sojourn in the foreign affiliates. Also, foreign affiliates may, either in response to performance requirements imposed by the host country or because of distinct cost advantages, train or establish local suppliers of components and parts. This too would be a channel for spillovers.

Another potent channel for spillovers – or, more to the point, growth of productive efficiency – is competition. The theory here is that the entry of foreign affiliates increases competition in the market place and locally owned firms are compelled to increase their productive efficiency. This is the

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sort of efficiency recognized in the literature as X-efficiency rather than allocative efficiency. Finally, locally owned firms may learn marketing techniques and methods of penetrating export markets from export oriented foreign affiliates.

These propositions have been extensively tested in the context of FDI in developed and developing countries. (For a survey of the empirical literature see Gorg and Greenaway, 2001; Blomstrom and Kokko, 1998.) These econometric studies have produced a mixed bag of results, some identify positive spillovers from the presence of foreign affiliates in manufacturing industries, and others find them to be either negligible or negative.

Ever since the 1991 reforms and the relatively mild bout of reforms in the mid-1980s, a number of studies have investigated the impact of reforms on FDI and its efficacy in India's manufacturing sector. A study on the mid-1980s liberalization efforts found that both domestically owned firms and foreign affiliates in the chemicals and machinery industries increased their investments, their imports of capital goods, their in house research and development (R&D) expenditures and imports of technology. There was, however, no such growth of investments by foreign affiliates in the pharmaceuticals industry, mostly because of the absence of protection of intellectual property legislation in India at that time (Siddharthan and Pandit, 1998). A variant of this finding is that, over the period 1980-1994 (which includes both the liberalization episodes), there were technology spillovers in the pharmaceutical industry of India, but only between TNCs themselves with little impact on domestic firms (Feinberg and Majumdar, 2001). Here again weak protection of intellectual property is seen as the reason for the absence of spillovers from TNCs to locally owned firms in the pharmaceuticals industry.

There are also studies that identify positive spillovers. A study based on stochastic frontier analysis, utilizing data for 368 medium and large sized firms in India's manufacturing sector, finds that there were positive spillovers from FDI in science based industries, but only in the case of domestic firms that possessed significant R&D capabilities. In the sub-group

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of “non-science” industries, the presence of foreign affiliates had compelled domestic firms to increase their productive efficiency (Kathuria, 2001). In addition to these econometric studies, there are also case studies of linkages and technology transfer between foreign affiliates and locally owned firms relating to specific TNCs in India and specific industries such as India’s truck manufacturers (Lall, 1980, 1983). These studies, shorn of the statistical and methodological problems that beset most econometric studies, identify spillovers and more specifically linkages that are undertaken by TNCs with a view to promoting productive efficiency and minimizing costs.

Another recent study (Mahambare, 2001), based on a sample of 2,417 firms in the manufacturing sector for the period of 1988-1989 to 1997-1998 notes that foreign affiliates in chemicals, drugs and non-electrical machinery industries increased their exports in the post-reform period. There is also evidence to show that the reforms have had a favourable impact on the productivity of foreign affiliates. Vidya Mahambare (2001) notes an improvement in the efficiency of foreign affiliates in the post-reform period. The analysis – based on data envelopment technique – reports that 61% of foreign affiliates showed an improvement in efficiency after the reforms, compared to 35% of locally owned firms. Changes in the pattern of financing, namely a decline in the debt-equity ratio in the post reform period, also appears to exert a positive impact on the efficiency of foreign affiliates in chemicals, inorganic chemicals, drugs, computer hardware and software industries.

As stated earlier, statistical studies on spillovers yield mixed results. But they do identify a number of factors that are likely to promote spillovers of technology and know-how from foreign affiliates to locally owned firms. First, the magnitude of spillovers tends to be high in industry segments in which the gap in technological capabilities between foreign affiliates and locally owned firms tend to be narrow. Second, spillovers are likely to be high when the competition in the market place between locally owned firms and foreign affiliates tends to be intense. Third, the extent and magnitude of spillovers differ between industries and host countries. Fourth, several studies show that spillovers are proportional to the magnitude of foreign

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presence, measured by shares of foreign affiliates in total equity or sales of the relevant industry groups. Fifth, local capabilities (including R&D and human skills) sustain high levels of spillovers. Finally, analogous to the last proposition, the liberalization of foreign trade, increased competition and development of local infrastructure all promote spillovers.

The message of all this is clear. Externalities or spillovers of technology are significant sources of growth and technical change, and FDI is a major engine of such spillovers. Increased volumes of FDI alone, however, are unlikely to generate widespread spillovers. In the absence of competition and cooperant factors such as local R&D and human skills, spillovers from FDI may be limited. Put another way, FDI is a catalyst of technical change and growth; it cannot be expected to be the prime mover. Indeed, empirical research suggests that FDI is most effective as an agent of change in economies that possess a threshold level of human capital and skills and in those economies that have attained a threshold level of growth (Balasubramanyam, Salisu and Sapsford, 1999; Blomstrom, Lipsey and Zejan, 1996).

In sum, in the absence of the necessary ingredients and cooperant factors, large volumes of FDI alone may be ineffective in promoting growth and may even be counter-productive. For these reasons the exuberance relating to the role of FDI in the growth process and exhortations that India should adopt a wide open doors policy towards FDI should be tempered by a recognition of the conditions necessary for the effective utilization of FDI.

### **Policy framework**

The 1991 reforms considerably relaxed the FDI regime. The issue though is how much further should India go on the road to liberalization and what are the specific policies it should adopt to reach the official target of \$10 billion of FDI inflows per annum.

The policy proposals may be divided into two broad sets. The first set includes general policies designed to remove

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product and factor market distortions of various sorts, policies designed to promote infrastructure facilities and growth of human capital and policies designed to promote R&D and competition in the economy. The second set includes specific policies designed to attract FDI, such as the transparency of rules and regulations, the abolition of red tape and delays in the approval of FDI projects, the removal of ceilings on the amount of equity foreign affiliates are entitled to hold and the establishment of export processing zones (EPZs) designed to attract FDI.

The evidence from statistical studies and the theoretical literature strongly endorses the proposition that the first set of general policies listed above is conducive to both increased flows of FDI and its efficacy in promoting development objectives. A liberalization of the foreign trade regime, for instance, may remove product market distortions that bias investment in favour of protected domestic markets and promote exports. A liberalization of the foreign trade regime does not imply an all-out export-promotion strategy with attendant export subsidies and various other incentives for exports. As suggested by Jagdish Bhagwati (1978), a distortion free regime is a neutral regime that does not favour either export-oriented industries or import-substitution industries, but allows comparative advantage to determine the allocation of investments between the two groups. There is some statistical evidence in support of the proposition that such a neutral regime attracts both relatively large volumes of FDI and promotes its efficacy (Balasubramanyam, Salisu and Sapsford, 1996). Again, the elimination of stringent labour laws and the abolition of policies that restrict the entry of firms into areas reserved for small-scale industries would also remove distortions in the economy and promote competition and productive efficiency. Policies that emphasize investment in human capital and R&D would be attractive to both foreign affiliates and locally owned firms and promote spillovers of technology and know-how from foreign affiliates to locally owned firms.

The second set of policies may be a bit more problematic than the first set. The exception here is the need to eliminate the red tape and delays associated with the administration of the

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FDI regime. These delays and cumbersome bureaucratic procedures are a factor in the relatively low volumes of FDI in India. It is reported that it takes ten permits to start a business in India against six in China, while the median time it takes is 90 days in India against 30 days in China. And a typical foreign power project requires 43 clearances at the central government level and another 57 at the state level (*Financial Times*, 2003).

The suggestion that the present policy – which requires government approval for projects that involve foreign share of equity in excess of 51% – should be scrapped in favour of automatic approval up to 100% of equity except in the case of selected projects is controversial (Bajpai and Sachs, 2000). It is arguable if such automatic approval of 100% foreign-owned projects would necessarily increase competition in the market place and serve consumer interests. It may result in the establishment of foreign owned monopolies and eliminate nascent domestic firms with a potential for growth. The belief underlying this suggestion of a wide-open doors policy for FDI is that relatively large volumes of FDI necessarily promote growth and development objectives. It is not the volume of FDI but its quality and the environment in which it operates that determine its contribution to development.

As stated earlier, FDI is a superb catalyst of development but not an initiator, and it can effectively function as a catalyst only in the presence of cooperant factors such as a threshold level of human capital and the ability of indigenous firms to adapt and restructure the know-how and technology provided by foreign affiliates to suit local factor and product markets. In the absence of these factors, the social rates of return to FDI may be low, although private rates of return to foreign affiliates on their investments may be relatively high.

The establishment of EPZs is another policy popular with most developing countries. India too has established a variety of EPZs, export-oriented units and more recently special economic zones. While the zones are not restricted to foreign affiliates, one of their principal objective is the promotion of FDI. It is the belief that foreign affiliates would be attracted to zones that permit duty free imports of materials and

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intermediates and place no restrictions on the export of final goods. These zones, with the exception of export-oriented units, also provide infrastructure facilities, telecommunication facilities and exemptions from local taxes to the firms located in the zones. However, the record of these zones in promoting exports and attracting FDI appears to be poor. Whilst there are no data on the volume of FDI in these zones, it is unlikely that they have attracted large volumes as the total volume of FDI in the country is relatively low. The total absolute value of exports from these zones is reported to have increased from Rs 48 billion in fiscal year 1997/98 to Rs 86 billion in 2001, but their share of total exports increased only marginally from 3.7% in 1997/98 to 4.2% in 1999/00 (WTO, 2002).

This poor performance of the zones is in part due to the cumbersome red tape and regulations associated with the operations of these zones. The problem with EPZs, however, may be much more general, residing in the nature of these institutions. They are in effect designed to offset distortions of various sorts present in the economy that bias resource allocation in favour of specific industries. In an economy that is rife with tariffs and non-tariff barriers to imports, both domestic and foreign resources would be attracted to protected domestic market-oriented industries away from export-oriented industries. EPZs are designed to offset this bias against exports, with the provision of various sorts of incentives, including duty free imports and fiscal incentives for the production of goods and services destined for the export markets. They are in the nature of small islands of free trade resident in a sea of protectionism.

EPZs may be successful in promoting exports and FDI if they are able to attract resources over and above those that already exist in the economy. It is, however, possible that resources from elsewhere in the economy would be diverted to the zones with very little addition to existing resources. Labour-intensive export oriented investment elsewhere in the economy may be relocated into the zones because of the various sorts of incentives they provide. In such cases, there would be very little addition to the total volume of exports of the economy, merely a reallocation of existing exports, achieved at a cost in terms of the incentives the zones provide. Such relocation of exports may

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occur even in the presence of fresh inflows of FDI into the zones. Foreign affiliates may successfully attract labour from export industries located elsewhere in the economy by paying relatively high wages. The increased wage payments paid by foreign affiliates would be a gain to the economy, but this gain should be set against payments in the form of dividends and profits the foreign affiliates earn.

Such relocation may explain the observed fact that the absolute volume of exports from the zones in India has grown, but the share of the zones in the total value of exports of the country has hardly increased. In this context the suggestion that the sluggish exports of the EPZs in India are “partly because some EPZs have accounted for a large share of the total export earnings of EPZs, while the share of others has fallen; this superior export performance may be related to infrastructural and locational advantages provided by some of the EPZs rather than the incentives themselves”, is of interest. (WTO, 2002, p.61). The implication of this statement is that there may be a relocation of exports between the zones themselves, and it is location and infrastructure facilities that promote exports rather than incentives such as tariff and tax concessions. In any case, EPZs are an attempt at offsetting distortions present elsewhere in the economy but not their removal. As Arvind Panagariya (2000) cogently argues, the correction of one distortion by another distortion may not be any more efficient than leaving the original distortion in place. This is because the introduction of the corrective distortion, such as EPZs that are essentially export promotion measures, not only adds to the existing distortions but also reduces the pressure to eliminate the existing distortions in place. It should be recognised that EPZs are much more likely to be successful when they are part of an orchestrated export strategy rather than an adhoc policy to counter distortions elsewhere in the economy. It could, however be argued that, contrary to India’s experience, EPZs have been successful in promoting exports and attracting FDI in other developing countries such as China. Arguably FDI and the growth of exports in China may not have been any less than what it is now in the absence of EPZs. Here again it is the location and infrastructure facilities China provides and not EPZs *per se*, which may account for China’s superior

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performance. There are also other reasons specific to China, discussed earlier that explain China's superior performance.

The relatively low volumes of FDI India has attracted are to be attributed to the overall economic policies of the country which, amongst other things, have failed to remove the pervasive distortions in the economy. These include not only the stringent labour laws and an array of subsidies and incentives designed to cater to special interest groups, but also relatively high tariffs and restrictions on imports. In sum, policies that provide level playing fields for both domestic firms and foreign affiliates are much more likely to attract both increased volumes of FDI and promote its efficacy than specific policies geared to foreign affiliates.

## **Conclusions**

FDI is a superb conduit for the transfer of technology and know-how to developing countries. This message has not been entirely lost on India's policy makers. The 1991 economic reforms, a watershed in India's economic development strategy, signalled a major departure from the highly regulated FDI policy framework of earlier years and removed many of the restraints on ownership and the composition of FDI. These policies have had an impact on inflows of FDI: annual inflows since 1991 are appreciably higher than those during the pre-reform years. Even so, the volume of FDI in India is much lower than that in other developing countries, and is well below the Government's target of \$10 billion of FDI inflows per annum.

This article has argued that the reasons for the relatively low volumes of FDI India attracts are to be sought in the pervasive factor and product market distortions generated by the overall policy framework and not entirely due to the FDI policy regime in place. The operation of the regime in practice, however, appears to be riddled with excessive delays and red tape with attendant opportunities for rent seeking. The article has no quarrel with the advocacy of policies designed to remove various sorts of distortions in product and factor markets, the reform of labour laws and the promotion of infrastructure and the growth of human capital. These are policies that should be

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adopted in the interests of both domestic investment and FDI. Indeed, a level playing field for one and all may be a much better bet than specific policies geared to the promotion of FDI.

The country needs to put its house in order if it is to attract increased volumes of FDI. In the absence of an overall policy framework designed to remove the pervasive product and factor market distortions in the economy, throwing all doors wide open to FDI is unlikely to be successful.

The article has also argued that, for a variety of reasons, China, with its spectacular success in attracting FDI, may not be a role model for India. In any case, large volumes of FDI alone are not a panacea for the development problem. Advocacy of FDI should be tempered by the recognition that it is a superb catalyst of growth and not an initiator, its efficacy in promoting development objectives is conditioned by the presence of cooperant factors in the host economies and it is most effective in countries that possess a threshold level of human capital and infrastructure facilities. The optimum level of FDI a country should aspire for is conditioned by its history and the stage of its industrialization, the sources of FDI it has ease of access to, and its endowments of cooperant factors and the sort of institutions it possesses to facilitate and monitor the operations of foreign affiliates. ■

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# The newly emerging TNCs from economies in transition: a comparison with Third World outward FDI

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Wladimir Andreff\*

In the 1990s, a new economic phenomenon emerged: outward foreign direct investment and newly emerging transnational corporations from post-communist economies in transition. They are different from the former “red multinationals”. They share a number of common features with Third World transnational corporations in their first stage of development in the late 1970s. These similarities suggest that all emerging transnational corporations – from economies in transition and the Third World – can be analyzed in the same general theoretical framework provided by the investment development path model. An econometric test (ordered logit) carried out on a sample of 176 countries confirms that outward foreign direct investment can be explained mostly by the level of economic development of home countries. The industry distribution of gross domestic product in the home country also has an impact on the level of outward foreign direct investment. The test, however, does not confirm a link with the level of technology. Policy recommendations gravitate around the removal of restrictive policies, though economies in transition should not rush into promotion. The future of the newly emerging transnational corporations is expected to follow a trend similar to that of outward foreign direct investment from newly industrializing countries.

**Key words:** economies in transition, investment development path, newly emerging transnational corporations, outward foreign direct investment

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\* Professor of Economics at the University Paris 1 Panthéon-Sorbonne, Honorary Director of the research laboratory of the Centre National de la Recherche Scientifique on Reforming and Opening Post-Socialist Economic Systems (ROSES) and President of the International Association of Sport Economists. Contact: [andreff@club-internet.fr](mailto:andreff@club-internet.fr).

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## Introduction

In the late twentieth century, foreign direct investment (FDI) from post-communist economies in transition emerged as a new phenomenon.<sup>1</sup> The volume of this outward FDI has increased fast since 1995, although its degree may be overstated slightly due to non-systematic data coverage before 1998 (UNCTAD, 1998 to 2001). Before that, the coverage was intermittent as, for example, in the last United Nations survey devoted to East-West business (UNTCMD, 1992).

Part of this article gathers empirical evidence on this emerging phenomenon. Nevertheless, it also makes an attempt to test some hypotheses that may pave the way for an analytical framework explaining the spread of newly emerging transnational corporations (TNCs) from economies in transition. Here, the task is similar to the one faced by those first economists who analyzed the emergence of Third World TNCs a quarter of a century ago. Some assumptions and variables that had been pointed out when analyzing outward FDI from developing countries – in particular from the newly industrializing economies (NIEs) – may be of some help when dealing with TNCs from economies in transition, too. Such a comparison may be a first step towards an overall approach to the common features of expansion abroad by emerging TNCs and their determinants.

The first issue is to check whether the newly emerging TNCs from economies in transition actually are some sort of “new animals”. Part of the economic literature traces them back

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<sup>1</sup> In this article, the sample of 26 economies in transition encompasses Central and Eastern Europe (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia), the Baltic States (Estonia, Latvia, Lithuania), the 12 members of the Commonwealth of Independent States (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Republic of Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan), countries of the former Yugoslavia (Bosnia and Herzegovina, Croatia, TFYR Macedonia, Slovenia), and Albania. The paucity of data availability determines the size of the sample, and the exclusion of Serbia and Montenegro.

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to the development of outward FDI from the then members of the former Council for Mutual Economic Assistance (CMEA), from the 1960s on. But outward FDI from economies in transition today is not simply a smooth follow-up of the so-called “red multinationals” inherited from the past. The latter had sunk in the economic recession and the liquidity crisis that accompanied the early years of transition. New outward FDI has come from an investment recovery, both inward and outward.

A next section of the article focuses on a comparison between the new TNCs from economies in transition and Third World TNCs. Since economies in transition are not yet fully-fledged post-industrial market economies, it is relevant to compare them with the NIEs whose best performing enterprises had started their transnational expansion in the 1970s. Third World TNCs and newly emerging TNCs from economies in transition may hence share common variables. An integrated analytical framework is thus suggested, inspired by the investment development path (IDP) model, in which independent variables are tested for all emerging TNCs, either from economies in transition or from developing countries together. A sample of 176 countries – delineated by data availability – consisting of economies in transition, developing countries and all developed market economies, is used for the econometric test. It confirms that the IDP model is relevant for outward FDI from all the countries in the sample, including the 26 economies in transition. Some policy recommendations that ensue from this evidence are presented in the next section. The conclusion sketches briefly the possible future of these newly emerging TNCs.

### **From “red multinationals” to the recovery of outward FDI**

A number of former socialist, Soviet and Eastern European enterprises started to invest abroad in the late 1960s (Hamilton, 1986), in the wake of the Brezhnevian economic reforms through which CMEA countries opened up to non-CMEA trade. These firms attracted considerable attention in the 1970s, when negotiations on a draft United Nations Code of Conduct on

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Transnational Corporations were underway. The United Nations Centre on Transnational Corporations, established in 1975, was entrusted, among other things, to collect information on FDI from CMEA countries, although the official CMEA doctrine was to deny the existence of anything that could look like a socialist TNC. On the other hand, a provocative book (Levinson, 1977), in a sub-chapter entitled “the communisation of the market economy”, described some parts of the FDI outflows from the Union of Soviet Socialist Republics (USSR) and Eastern Europe in banking and insurance, trade, import-export, as well as in oil and gas, the chemical industry, transportation, civil engineering, the steel industry, engineering and mining.

### *Strange “red multinationals”*

A hot debate arose, triggered by several studies.<sup>2</sup> The number of studies was probably disproportionate compared to the real significance of outward FDI from CMEA countries. According to the highest estimate, its stock never exceeded \$1.5 billion, i.e. much less than 1% of the current outward FDI stock from the United States. A generally accepted estimate (Zaleski, 1983) was \$724 million in 1978, excluding FDI in banking, assessed to be another \$325 million. The overall amount was slightly over \$1 billion, i.e. 0.3% of the worldwide FDI stock in 1978 (Andreff, 1987). Carl McMillan published the last estimate, provided for 1990, in a study prepared for the United Nations (UNTCMD, 1992): Eastern Europe’s outward FDI stock was evaluated to \$1,226 million, excluding outward FDI from Yugoslavia. For the same year, UNCTAD published a figure of \$1,483 million, including Slovenian outward FDI. As a whole, Eastern European outward FDI was less than 0.1% of the worldwide stock in 1990 (table 1). This percentage, compared with the one of 1978, shows that the Eastern European outward FDI stock grew slowly during the 1980s. It eventually shrank at the outset of the transition to market economy, even though the figure of 0.01% of the worldwide FDI stock in 1992, displayed

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<sup>2</sup> Wilczynski, 1976; Zurawicki, 1979; Andreff, 1982; Zaleski, 1983; Hamilton, 1986; McMillan, 1987; Grou, 1989; Gutman, 1990; Sokolov, 1991; UNTCMD, 1992.

in table 1, obviously is an underestimation. However, seen from where it was in 2000, outward FDI from post-communist countries in 1990 amounted to little (8.6% of its 2000 stock).

**Table 1. Outward FDI stock of CEE countries, 1983-2000**

(Million dollars)

Home country	1983	1987	1990	1992	1993	2000
Bulgaria	17	27	54	..	..	88
Czechoslovakia <sup>a</sup>	12	30	99	65	86	1 104
Hungary	39	40	134	..	71	2 012
Poland	52	23	146	176	194	1 491
Romania	32	41	93	25	32	122
Slovenia	..	..	258	..	259	655
USSR <sup>b</sup>	388	378	699	..	..	11 637
Total <sup>c</sup>	540	539	1 483	266	642	17 109
% of worldwide stock	0.1%	0.06%	0.09%	0.01% <sup>d</sup>	0.03% <sup>d</sup>	0.29%

*Sources:* McMillan, 1987; UNTCMD, 1992, UNCTAD, 2002; and East-West Project, Carleton University.

<sup>a</sup> In 1993 and 2000, Czech Republic plus Slovakia.

<sup>b</sup> In 2000, Russian Federation.

<sup>c</sup> Totals are incomplete due to information missing for some countries such as the former German Democratic Republic.

<sup>d</sup> Significantly underestimated due to missing information.

In the pre-transition period, the parent companies of the “red multinationals” were State-owned enterprises, primarily State-run foreign trade organizations. Their foreign affiliates were mostly located in developed market economies, according to estimates published between 1977 and 1990. In developed countries, they preferred to invest in trade, banking and finance, and then in other services. In developing countries, the “red multinationals” were more concentrated in industries based on raw materials and power consumption. According to UNTCMD (1992), in 1990 socialist TNCs had 863 affiliates in developed countries. After 1984, the year when most CMEA countries started to withdraw from developing countries, the number of affiliates operating in the Third World decreased.

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The CMEA official doctrine argued against these foreign affiliates behaving in the same way as the affiliates of developed country TNCs. It claimed that socialist firms were different because:

- their foreign affiliates were mostly conduits of their home country's foreign trade;
- they were small-sized businesses;
- in the developed host countries, they were concentrated in service industries, not in manufacturing;
- they were hardly profitable – and often loss-making; and
- the parent company's objective was to collect hard currencies in order to finance the home country's imports and trade deficit, rather than to make business profits.

However, when located abroad, Eastern European firms usually hired local manpower in their affiliates, supervised by expatriated managers; and they often owned a majority stake or the whole stock of their foreign affiliates (Andreff, 1982). On the other hand, specific to “red multinationals” when compared to other TNCs was a slower growth of their FDI during the 1980s. Centrally planned economies created systemic pressures and hindrances to outward FDI by State-run enterprises, to such an extent that Andreja Jaklic and Marjan Svetlicic (2001) contended that their investment abroad was either of a system-escape type or part of the overall policies of the respective governments.

Other obstacles to outward FDI from former socialist countries were ideological motives of political leaders, foreign trade restrictions, hard currency shortages, the low quality of tradable goods, central authorities' interference in the firms' investment decision processes, and mandatory plan fulfilment before any foreign expansion. In such a context, foreign affiliates often did not make profits since the parent company's resources were utilized for fulfilling the planned objectives, and not for profit making. “Red multinationals”, just like any other socialist enterprise, were not subject to a hard budget constraint, or a solvency requirement or a bankruptcy threat even though their foreign affiliates were confronted with a market environment

in host countries. In the last resort, they could always be bailed out. Finally, being State-owned, “red multinationals” had no specific ownership advantages (or even had disadvantages) over local companies in host countries.

The question is to know whether the new TNCs emerging in the economies in transition can be differentiated from these former “red multinationals” or whether they are increasingly similar to other TNCs. It will be shown in this article that the new TNCs from economies in transition are closer to the Third World TNCs that emerged in the late 1970s. Whether they were “red multinationals” or “red herrings” (to phrase it like Geoffrey Hamilton), socialist Eastern European firms investing abroad were strange animals until they disappeared with the economic system that generated them. Table 2 displays their specific features.

**Table 2. Main features of “red multinationals”, Third World and Western TNCs**

Features	“Red multinationals”	Third World TNCs in the late 1970s <sup>a</sup>	Western TNCs
Main owners	State	Private or State	Private
Ownership specific advantages over local companies	no	moderate	significant
Home country market	planned economy	small, poor	big, wealthy
Home country obstacles to outward FDI	strong	moderate	no
State interference in TNC strategy	strong	medium	weak
Average TNC size	small	small and medium	medium and big
Location of foreign affiliates	developed countries	neighbouring developing countries	developed countries
Number of host countries	medium	small	large
Key industries	trade	manufacturing	services industry
Product quality	low	medium	high
Average profitability	non profitable	slightly profitable	profitable
Growth in the 1980s	slow	sustained	rapid

*Source:* the author.

<sup>a</sup> TNCs from economies in transition in the 1990s share a number of common features with Third World TNCs in the late 1970s.

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### *Transition: outward FDI recession and recovery*

In the early years (1990-1993) of post-communist transition, former socialist TNCs declined markedly. Although data are not exhaustive, table 1 shows the decline. As early as 1990, 89 foreign affiliates located in developed countries were closed down as well as a number of those in developing countries. Moreover, after 1990, former socialist TNCs were facing several constraints that dried up their liquidity and their capacity to finance their affiliates abroad. Most foreign affiliates became under-capitalized and could not survive without new capital transfers from parent companies between 1990 and 1993. Some socialist TNCs went bankrupt while some others were taken over by a (usually foreign) private investor. They slowed down their outward FDI dramatically and, in some economies in transition (such as Slovenia), firms almost ceased investing abroad (Svetlicic, 1997). Former socialist TNCs were surrounded by a deep transformational recession, a loss of their traditional CMEA outlets, a credit crunch resulting from restrictive stabilization policies, an even harsher shortage of hard currency (the currency available was primarily used to stabilize the exchange rate and repay the external debt), and a disorganization of domestic production and distribution networks.

In the economies in transition, each firm was compelled to adjust to price liberalization, subsidy cuts, new bankruptcy legislation and enterprise liquidation rules and a reforming banking system. All these adjustments hardened the firms' budget constraint. Due to the adjustment shock, no more money was available for investing abroad. Several socialist TNCs were disbanded, others disintegrated into a number of smaller privatized firms. In addition, system-escape FDI lost its importance (Jaklic and Svetlicic, 2001), so that some Eastern European firms divested or closed down their affiliates in Western Europe and developing countries. Incumbent managers were more preoccupied with the outcome of their enterprises' privatization and manoeuvres aimed at their entrenchment and control over the corporate governance structure (Andreff, 2000, 2003) than looking for investment opportunities abroad. Sometimes, managers in public and privatized enterprises were

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accused of asset stripping to by-pass firms abroad, a behaviour that raised popular resentment against outward FDI. Legislation was even less favourable to outward than inward FDI in the early years of transition, except in Hungary. Public opinion in economies in transition did not support the sale of the “crown jewels” to foreign investors, but it was even more hostile to outward FDI, soon associated with capital flight.

Economic recovery took hold in most of Central and Eastern European (CEE) countries by 1993-1994 and, during the second half of the 1990s, in the Commonwealth of Independent States (CIS) countries. These economies became more stabilized after some success in curbing inflation and reducing their fiscal deficits. In an improved economic environment, entrepreneurial confidence resumed enough to trigger an investment boom in the domestic economy and, after a few years, to fuel decisions to invest abroad. A new wave of outward FDI took place in the *de novo* private sector, and old firms – either privatized or still state-run – resumed their foreign investment business, primarily in neighbouring countries (Jaklic and Svetlicic, 2001). This new expansion was boosted by the adoption of increasingly liberal regimes as regards to the regulation of both inward and outward FDI, namely in those economies in transition that were negotiating accession to the European Union (EU).

## **Macro- and micro-economic outlook**

### ***Outward FDI from economies in transition: a macroeconomic assessment***

The purpose here is not to analyze the annual fluctuations of FDI outflows from economies in transition. Rather, it is to observe the significance of the internationalization of Estonian, Hungarian, Polish, Russian, etc. firms that have invested abroad. Thus, stock (instead of flow) data are used, even though they are not homogeneous from one economy to the other and sometimes they are estimated as a cumulative flow over years (UNCTAD, various years). The real take-off of outward FDI dates back to 1995-1999, depending on the economy in transition. The value of

outward FDI from the 26 economies in transition rose six fold between 1994 and 1995, nearly doubled from 1995 to 1997, and doubled again from 1997 to 2000 (table 3), according to UNCTAD data. Even if published data are considered to be non-comprehensive before 1995 (UNCTAD, 1998) – and this may explain the statistical leap forward in 1995 –, it is no longer so in the following years.

**Table 3. Outward FDI stock of economies in transition, 1994-2000**  
(Million dollars)

Home country	1994	1995	1996	1997	1998	1999	2000	2000 outflow
Armenia	..	..	..	..	12	25	33	8
Azerbaijan	..	..	..	..	137	473	652	179
Belarus	..	8	..	..	4	16	16	0
Georgia	..	..	..	..	39	40	57	17
Kazakhstan	..	..	..	..	10	14	18	4
Kyrgyzstan	..	..	..	..	..	1	1	0
Moldova, Rep.	..	18	19	19	19	19	19	0
Russian Federation	386	3 015	1 178	6 410	7 377	8 586	11 637	3 050
Tajikistan	..	..	..	..	..	17	23	6
Turkmenistan	..	..	..	..	..	23	31	8
Ukraine	8	97	92	134	98	105	106	1
Uzbekistan	..	..	106	222	282	264	321	57
CIS sub-total	394	3 138	1 395	6 785	7 978	9 583	12 914	3 330
Bulgaria	..	105	37	35	4	90	88	-2
Czech Republic	206	345	386	548	804	698	784	118
Estonia	12	68	86	215	198	272	429	157
Hungary	115	383	493	900	1 101	1 565	2 012	532
Latvia	..	231	116	222	281	244	241	8
Lithuania	..	1	3	26	16	26	29	13
Poland	223	539	735	678	1 165	1 365	1 491	126
Romania	33	121	43	114	122	133	122	-11
Slovakia	75	374	95	234	668	296	320	23
Slovenia	..	504	366	424	563	607	655	48
Sub-total	664	2 671	2 360	3 396	4 922	5 296	6 171	1 012
Albania	36	48	58	68	69	76	82	6
Bosnia and Herzegovina	..	13	0	5	41	40	40	0
Croatia	..	703	453	638	992	1 024	1 052	28
TFYR Macedonia	..	..	..	..	3	4	5	1
Sub-total	36	764	511	711	1 105	1 144	1 179	35
Total	1 094 <sup>a</sup>	6 573	4 266	10 892	14 005	16 023	20 264	4 377
% of worldwide stock	0.05% <sup>a</sup>	0.23%	0.14%	0.32%	0.34%	0.32%	0.34%	0.38%

Source: UNCTAD, various years.

<sup>a</sup> Significantly underestimated due to missing information.

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As a result, the share of outward FDI from economies in transition in worldwide outward FDI stock increased from its 1997 level of 0.3% to 0.34%, in spite of the 1998 Russian financial crisis acting as a brake on FDI outflows from several CEE economies in 1998 and 1999. With \$20 billion in 2000, the outward FDI stock from economies in transition exceeded the outward FDI stock from Africa (\$19 billion without South Africa), although it reached only 18% of the outward FDI stock from Latin American countries and 3.5% of that from Asian countries. By 2000, the outward stock of all economies in transition together was as high as that of Argentina (\$20 billion). However, one economy in transition is by far the most significant home country as regards to the absolute volume of outward FDI: the Russian Federation. Its share in the overall outward FDI stock from economies in transition rose from 46% in 1995 to 57% in 2000. Then came Hungary (10%), Poland (7%), Croatia (5%), the Czech Republic (4%) and Slovenia (3%).

These divergent patterns among different economies in transition as home countries have their roots in the legacy from the past (the number of foreign affiliates that survived from socialist times), the date of economic recovery, economic policy towards outward FDI, the political will of a country to be a major actor on the international scene (in the case of the Russian Federation), and industry-specific factors. The expansion of outward FDI from economies in transition is partly led by a group of front-runner home countries such as Croatia, Estonia, Hungary, the Russian Federation and Slovenia. On the other hand, some newcomers such as Armenia, Belarus, Kazakhstan, Lithuania, TFYR Macedonia, Tajikistan and Turkmenistan emerged between 1997 and 1999 as new outward investors, although the volume of their outward FDI remains small. In 1999, economies in transition as home countries could be differentiated into three groups (table 4) on the basis of the ratios of outward FDI stock to gross domestic product (GDP), outward FDI stock per capita, FDI outflows as a percentage of domestic gross fixed capital formation and the growth of FDI outflows in 1999 and 2000. Group 1 may soon reach a relatively advanced stage of internationalization following the IDP model (see

below). Group 3 may lag behind in the second stage of this model for decades. Group 2 is in between.

**Table 4. Main features of outward FDI in economies in transition, 1998-2000**

(% and million dollars)

Countries	Outward FDI stock/ GDP, 1999	Outward FDI stock/ capita, 1999	FDI outflows/ GFCF, 1999	Change in FDI outflows (\$ million)	
				2000/1999	1999/1998
<b>Group 1</b>					
Estonia	5.3	194.3	6.4	77	74
Azerbaijan	10.6	62.2	25.5	199	-157
Russian Federation	2.3	58.5	6.5	952	1 087
Hungary	3.2	155.0	2.4	-232	283
Slovenia	2.9	303.5	n.a.	27	10
Latvia	3.7	101.7	1.0	-37	-9
Croatia	5.1	227.6	0.7	-62	-7
<b>Group 2</b>					
Slovakia	1.5	54.8	1.8 <sup>a</sup>	-518	395
Czech Republic	1.3	67.8	0.6	-37	28
Poland	0.9	35.2	0.8 <sup>a</sup>	-285	95
Bulgaria	0.7	11.0	0.9	17	-19
Armenia	1.3	6.8	4.3	1	-5
Albania	2.9	23.8	..	6	-1
Moldova, Rep.	1.7	4.4	..	0	0
Lithuania	0.2	7.0	..	5	4
Ukraine	0.3	2.1	..	11	-6
Tajikistan	..	2.7	4.0	17	-9
Romania	0.4	5.9	..	25	-27
<b>Group 3</b>					
Uzbekistan	..	10.9	..	-68	65
Georgia	..	7.4	..	-43	16
Macedonia, TFYR	0.1	2.0	..	0	0
Turkmenistan	..	4.7	..	-113	57
Belarus	0.1	1.6	..	-2	0
Bosnia and Herzegovina	1.5	9.3	..	..	..
Kazakhstan	..	0.9	..	-4	0
Kyrgyzstan	..	0.2	..	..	..

Sources: UNCTAD, 2001 and EBRD, 1999.

**Table 5. Geographical distribution of outward FDI stock from selected economies in transition, 1998-2000**

(%)

Host country Home country/Year	Croatia 2000	Czech Rep. 2000	Estonia 2000	Hungary 2000	Latvia 1999	Russian Fed. 2000	Slovakia 1999	Slovenia 1998
Bulgaria						<1.0		
Czech Republic	..	..	..	..	..	..	36.0	..
Estonia	..	..	..	..	..	1.0	..	..
Hungary	0.5	2.0	..	..	..	..	10.0	1.0
Latvia	..	..	71.0	..	..	7.0	..	..
Lithuania	..	..	24.0	..	1.0	..	..	..
Poland	68.0	25.0	0.5	1.0	..	3.0	3.0	7.0
Romania	..	1.0	..	8.0	..	..	..	1.0
Russian Federation	..	16.0	1.0	2.0	1.0	..	4.0	1.0
Slovakia	-5.0	38.0	..	48.0	..	..	..	..
Ukraine	..	2.0	..	0.0	1.0	..	13.0	1.0
CEE	174.0	85.0	88.0	61.0	4.0	25.0	69.0	82.0
European Union	33.0	9.0	-4.0	36.0	4.0	..	23.0	13.0
United States	-73.0	2.0	..	1.0	1.0	..	0.0	3.0
Developed countries	-41.0	11.0	-4.0	37.0	5.0	..	24.0	19.0
Developing countries	-34.0	3.0	2.0	4.0	90.0	..	2.0	2.0
Non specified	..	..	15.0	-2.0	1.0	..	5.0	-3.0

Sources: UNCTAD, 2000 and 2001; and Liuhito and Jumpponen, 2001b.

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A lack of detailed information hinders a description of the geographical distribution of outward FDI from economies in transition. According to table 5, except in the case of Latvia, the outward FDI stock of these economies is concentrated in a limited host area within CEE. It is basically a regional expansion, with crossed FDI between neighbouring economies. Lagging far behind is outward FDI in the EU. TNCs from economies in transition have little investment in developing countries, which hosted between 2 and 4% of their outward FDI stock, the Latvian exception set apart (see below).

There is even less detailed information on the industrial composition of outward FDI, except for a few countries. For instance, Hungarian outward FDI in CEE is concentrated in manufacturing, whereas it is much more focused on trading in Western countries (UNCTAD, 1997). In 2001, the Estonian outward FDI stock was mostly in banking and finance (40.4%), followed by real estate (23.5%), manufacturing (15.9%), transportation and communication (13.5%), trade (4.8%) and construction (0.8%); Varblane *et al.*, 2001). A glance at table 7 reveals that most of the 25 biggest non-financial TNCs from economies in transition in 1997-1999 were involved in transportation, oil and gas, pharmaceuticals, trade and the steel industry.

The ratio between the outward and inward FDI stock is rather low in most of the countries of the sample (table 6). The spread of outward FDI from economies in transition followed, with a few-year time lag, the growth of inward FDI in the same countries (Andreff and Andreff, 1997; Andreff, 1999, 2001). Until now, economies in transition are by far more important as host than home countries, i.e. a feature that compares with the NIEs 20 years ago. The only exception is the Russian Federation whose ratio is quite high for an economy in transition.

### ***Direct and indirect outward FDI***

One issue related to outward FDI from economies in transition is to know whether it is – and in which proportion –

**Table 6. Ratio between outward and inward FDI stock in countries in transition, 1995-2000**

(%)

Country	1995	1998	1999	2000
Armenia	..	3.7	5.7	5.7
Azerbaijan	..	4.4	13.0	14.5
Belarus	16.0	0.8	1.4	1.3
Georgia	..	18.6	13.7	11.7
Kazakhstan	..	0.1	0.2	0.2
Kyrgyzstan	..	..	0.2	0.2
Moldova, Rep.	19.1	6.9	6.0	4.3
Russian Federation	55.2	52.1	51.9	60.5
Tajikistan	..	..	17.7	19.2
Turkmenistan	..	..	4.1	4.7
Ukraine	10.7	3.5	3.2	2.8
Uzbekistan	-	35.5	30.8	33.6
CIS sub-total	30.0	25.7	26.9	30.8
Bulgaria	31.2	0.3	3.7	2.6
Czech Republic	4.7	5.6	4.0	3.7
Estonia	9.3	10.9	11.1	15.1
Hungary	3.8	6.9	8.1	10.1
Latvia	37.5	18.0	13.6	11.6
Lithuania	0.3	1.0	1.3	1.2
Poland	6.9	5.2	5.2	4.1
Romania	10.5	2.8	2.4	1.9
Slovakia	30.0	26.7	9.1	6.5
Slovenia	28.7	19.4	22.6	22.9
Sub-total	8.5	7.1	6.4	6.0
Albania	23.9	18.0	17.9	15.9
Bosnia and Herzegovina	..	..	24.2	14.2
Croatia	145.9	36.3	25.4	21.4
TFYR Macedonia	-	1.7	1.9	1.3
Sub-total	98.3	33.5	23.7	19.3
Total	15.4	13.6	13.0	13.5

Source: calculated from UNCTAD, various years.

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direct or indirect. Indirect FDI<sup>3</sup> is an investment abroad undertaken by an affiliate of a foreign TNC (for instance a French firm) that has been set up in a different host country (for example Romania). In such a case, this FDI outflow is *indirect* French FDI rather than a *direct* Romanian FDI. Since both direct and indirect FDI is included in outward FDI statistics, the volume of outward *direct* investment cannot be established. The regional concentration of the outward FDI of the economies in transition in CEE reflects, to some extent, the strategy of Western TNCs that have invested in Hungary, e.g. to use their Hungarian affiliates as a springboard for investing in Romania or Slovakia. Estonia is a hub for Western FDI in the whole Baltic area, while Slovenia and Croatia channel some western FDI to other newly independent States resulting from the breakup of the former Yugoslavia.

When the ratio of outward to inward FDI is relatively high in an economy, it may well be that this country is a hub for western FDI. This ratio was both non-negligible and increasing from 1995 to 2000 in Estonia, Hungary, Azerbaijan and the Russian Federation (table 6). Since it is not much likely that the Russian Federation and Azerbaijan are hubs for (still low) outward FDI to other CIS countries, only two economies in transition remain as hubs for western FDI: Hungary towards CEE and Estonia towards the Baltic States. Outward FDI from these two countries certainly contains a non-negligible share of indirect investment.

The same conclusion does not hold for the other 24 economies in transition but it is confirmed by the results of a recent survey covering a sample of 180 outward investors from five economies in transition (Altzinger *et al.*, 2002). In 2001, when using a 10% foreign equity share criterion, the percentage of indirect outward investors was 81.8% for Hungarian firms

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<sup>3</sup> UNCTAD's (1998, p. 145) definition is: "FDI by a foreign affiliate is *indirect* FDI, signifying that the resulting asset-stock is owned by the parent firm *via* the foreign affiliate, and that it represents, therefore, an indirect flow of FDI from the parent firm's home country (and a direct flow of FDI from the country in which the affiliate is located)".

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and 63.8% for Estonian firms – both hub countries – while it was 53.8% for Czech firms, 43.6% for Slovenian firms and 37.5% for Polish firms. When the criterion of foreign equity share is pushed up to 50%, indirect outward FDI is substantive in Slovenian firms – possibly a third hub country. A sample of 194 outward investing firms registered in Estonia contains 65% indirect investors, with 82% of the indirect investors owned by EU shareholders (Varblane *et al.*, 2001).

Thus, it is safe to assume that, within the overall outward FDI from economies in transition, a substantial share is actually *direct* investment.

### *Transnational strategies*

The breakup of a former socialist State into new independent States generates, *per se*, a number of firms whose assets are divided among two or various successor countries. They may be coined “institutionally founded” TNCs or “born international” TNCs<sup>4</sup> (Liuhto, 2001c); in other words, an “inherited transnationalization” gave rise to TNCs overnight (Jaklic and Svetlicic, 2001). Belonging to various successor States has made a number of firms transnational since the outset of transition, but most TNCs from economies in transition are genuinely transnational due to their new strategies abroad. For instance, if after the breakup, a Czech firm went on investing in Slovakia, and in addition expanded its FDI to, e.g. Hungary, Poland and Russian Federation, then it ought to be considered as a genuine TNC. Strategies of this kind have prevailed. Just to mention a few examples from the business literature, the Hungarian firm Richter Gedeon has set up a packing factory in the Russian Federation. Pharmavit is the first Hungarian investor in Romania. The Croatian firm Pliva Group has a network of 14 foreign affiliates and 14 foreign offices, primarily located in Europe, including production units recently acquired in the

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<sup>4</sup> Although in the case of Lasco the “born international” dimension also stems from the firm’s field of operation (simply out-flagging its ships without major change in its core business).

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Czech Republic, France, Germany and the United Kingdom. The Hungarian ceramist Zalakeramia has acquired a Croatian firm and a majority stake in the joint stock of Cesarom in Romania. Various surveys carried out by the Research Group for Russian and East European Business at the Lappeenranta University of Technology show that major TNCs from economies in transition are based in the most important outward investing country, i.e. the Russian Federation. The number of Russian affiliates registered abroad is estimated to be in the range of several thousands (Liuhto and Jumpponen, 2001b), whereas this number was only 160 in 1990.

The largest Russian TNC, Gazprom, has invested in Finland (25% of Gasum), Germany (35% of WinGas), Greece (50% of Prometheus Gas), Hungary (24.8% of TVK), Poland (49% of Europol Gas), and the Baltic States (31% of Eesti Gaas and 18% of Latvijas Gaze). The firm holds significant stakes in firms in all Central Asian and other CIS countries. It is the third biggest foreign investor in Poland. It has created a number of joint ventures, in particular in gas distribution and transportation, in association with ÖMV (Austria), Bulgargaz, Neste, Gaz de France, Royal Dutch Shell, Wintershall-BASF, Daimler Benz, Ruhrgas, DEPA (Greece), MOL (Hungary), SNAM (Italy), Edison, Heerema (Netherlands), PGNiG (Poland), Kovinotenica (Slovenia), SPP (Slovakia), Romgaz (Romania), British Gas and the Turkish firm Botas (Locatelli, 1998). This network of joint affiliates is completed by strategic alliances with a number of western TNCs whose aim is to gain access to new markets and new sources of finance (Heinrichs, 2000). In China, Gazprom has opened up an office and prospects for setting up a joint venture. It owns 70% of the Russian Federation's gas reserves (which means roughly one-third of world reserves), and controls practically all of Russia's 150,000 kilometre network of gas pipes. "What is good for Gazprom, is good for Russia" probably applies. Gazprom is involved, like many western TNCs, in FDI through acquisitions, having acquired a 24.8% share in the stock of the Hungarian Borsodchem in September 2000 (UNCTAD, 2001). By the same token, TVK (the first Central European producer of polyvinyl chloride) has become a Gazprom second-

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degree affiliate due to Borsodchem's share in TVK (at least until late 2000). After MOL's purchase of TVK's shares, disappointing to Gazprom, the latter has prospected an acquisition of Oriana, a Ukrainian firm in the process of being privatized. Oriana is the most important supplier of TVK. Gazprom may come into conflict with the strategy of another big Russian Federation-based TNC, LUKoil, which is also eager to acquire Oriana; a joint venture, LUKor, started operating early 2001, attracting the Government of Ukrain's preference in favour of LUKoil.

Genuine transnational strategies are also observed for other major Russian oil producers such as Yukos, Rosneft (though still state-owned), Slavneft, and Tatneft (Liuhto, 2001a). Russian firms in other industries, too, do invest abroad, e.g. RAO UES (the Russian monopoly for electricity production and distribution), Alrosa (the biggest Russian diamond producer), Norilsk Nickel, Russkiy Aluminiy, AvtoVAZ (the largest Russian car producer, which owns foreign branches in 70 countries), Alfa Bank and Vneshtorgbank (the foreign trade bank).

All these examples demonstrate that a number of Russian firms are genuine TNCs. This is not to say that the Russian outward FDI stock results from the strategies of *de novo* firms based in the Russian Federation. Several firms – including Gazprom – were only operating within the Soviet borders in former times. The breakup of the Soviet Union triggered their swift internationalization. Moreover, a non-negligible part of capital outflows leaving the Russian Federation is nothing but capital flight due to a difficult domestic investment climate. Russian outward FDI had reached 0.7% of the estimated value of capital flight in 1994, 5.3% in 1995, 3.1% in 1996, 23.6% in 1997 and 4.8% in 1998, according to Kari Liuhto and Jari Jumpponen (2001b). Russian capital is flowing to financial centres. Russian citizens have registered roughly 60,000 companies in international financial centres, according to an estimate by the Russian Ministry of the Interior (Kuorsalo *et al.*, 1999). On the other hand, a part of flight capital comes back to the Russian Federation – by way of round-tripping – as revealed by the fact that 4% of the Russian inward FDI stock in

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1999 originated from Cyprus (UNCTAD, 2000), while being financed by expatriated Russian capital. (For a comparison, 9.3% of Ukrainian inward FDI stock also originated from Cyprus, though financed by Russian and Ukrainian capitals.)

Outward FDI from economies in transition proceeds through a number of cross-border mergers and acquisitions (M&As), as exemplified by Gazprom. From a survey of 21 Czech, 12 Hungarian and 32 Slovene TNCs in 1998, it appeared that greenfield investment was the predominant mode of entry, accounting for, respectively, 70%, 85% and 74% of the expansion of the TNCs surveyed (Jaklic and Svetlicic, 2001). Only 20% of the Czech affiliates abroad had been set up through cross-border mergers and 10% by means of an acquisition. The figures were, respectively, 0% and 26% for Hungarian affiliates, and 12% and 3% for Slovene ones. One can conclude from this evidence that M&As are relatively exceptional, in distinction from the prevailing FDI trends in the world. Although Jaklic and Svetlicic admitted that their sample “cannot be taken as being fully representative”, the previous conclusion may well no longer be relevant after 1998. For instance, the Hungarian oil company MOL had 50.9% of its capital acquired by various international portfolio investors as of the end of December 1999 (Liuhto, 2001b), while it had acquired 36.2% of the joint stock of Slovnaft, the leading Slovak oil company. Furthermore, MOL signed an agreement in December 1999 with the Croatian firm INA, to merge with it. MOL is associated with PKN Orlen in the Polish oil market, including through shares in its affiliate Rafineria Gdanska. Finally, MOL competed with Gazprom for the control of TVK after Borsodchem had sold its stake of 15% in TVK to MOL. The latter, with 32.9% of TVK’s stock, is a major block holder enabling it to appoint four out of the eight directors in the TVK board. Similarly, Matav (Hungary) acquired 51% of the Macedonian MakTel in late 2000. Adding these examples to other existing business surveys provides a picture according to which, since 1999-2000, TNCs from economies in transition have increasingly resorted to M&As as significant modes of entry. Thus they have come closer to the worldwide trend of outward FDI at the moment.

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### *TNCs based in small countries in transition*

Due to incomplete information, UNCTAD (2001) was not able to include Gazprom in the list of the biggest TNCs based in economies in transition, though it is *the* biggest one (table 7). In fact, among the biggest TNCs from economies in transition, a good number of firms are based in small (all CEE countries, except Poland and Romania) or very small (Estonia, Latvia, TFYR Macedonia, Slovenia, less than 2.5 million inhabitants each) countries. Some TNCs from these small countries have a high transnationality index, such as Latvijas Kugnieciba (Latvian Shipping), Podravka, Gorenje, Pliva Group, Atlanska Plovidba, Krka, Adria Airways, Croatia Airlines or Lifosa. Such empirical evidence suggests that the small size of a country might explain, *per se*, the spread of these firms abroad, due to a tiny domestic market. This factor is sometimes referred to in respect of the expansion of Austrian, Belgian, Danish, Dutch, etc. TNCs. Amazingly, not a single Estonian TNC shows up in table 7, in which firms are ranked according to their asset value. This is probably due to the fact that 60% of overall Estonian outward FDI is concentrated in banking, finance and real estate (Kilvits and Purju, 2001) whereas only non-financial firms are covered in the table. Furthermore, major Estonian banks are now under foreign control: Hansapank is owned by the Swedish Swedbank and Ühispank by another Swedish bank, SEB.

The biggest TNC based in a small economy in transition is Latvian Shipping Co. (“Lasco”). The firm had begun as a consequence of the breakup of the USSR, managing a fleet of 90 former Soviet ships kept by the new Latvian State (Liuhto, 2001c). Although Lasco has reduced its fleet to 58 ships and has adopted a new focus on oil shipping, it is now the third most important firm in the industry, after Russia’s Novorossiysk and UNICOM. Lasco’s ships today benefit from flags of convenience, primarily in Liberia, Cyprus and Malta. Lasco controls two holdings in Liberia and Cyprus. The bulk of Lasco’s activities are located in Liberia, and this does explain the specific geographical distribution of Latvian outward FDI, concentrated in the Third World. Such a strategy is in tune with the other

**Table 7. The largest non-financial TNCs from economies in transition, 1997-1999**  
(%, million dollars and number of employees)

Transnational corporation	Country	Industry	Transnationality		Foreign	
			index <sup>a</sup>	assets	sales	employment
The 25 largest in 1999 (ranked by foreign assets)						
Lukoil Oil Co	Russian Federation	Oil, gas	29.8	3 236	4 642	10 000
Latvian Shipping Co	Latvia	Transportation	87.3	459	191	1 124
Hrvatska Elektroprivreda	Croatia	Energy	4.3	296	10	..
Podravka Group	Croatia	Food, pharmaceuticals	32.6	286	119	501
Primorsk Shipping	Russian Federation	Transportation	59.4	256	85	1 308
Gorenje Group	Slovenia	Electrical equipment	33.3	236	593	590
Far Eastern Shipping Co	Russian Federation	Transportation	38.8	236	134	263
Pliva Group	Croatia	Pharmaceuticals	39.7	182	385	2 645
TVK Ltd	Hungary	Chemicals	37.5	175	249	927
Motokov	Czech Republic	Trade	64.8	164	260	576
Skoda Group Plzen	Czech Republic	Conglomerate	10.6	139	151	1 073
Atlantska Plovidba	Croatia	Transportation	63.2	138	46	..
MOL Hungarian Oil&Gas	Hungary	Oil, gas	8.9	126	582	833
Krka	Slovenia	Pharmaceuticals	38.1	121	209	429
Adria Airways	Slovenia	Transportation	64.0	116	103	19
Petrol	Slovenia	Oil, gas	10.1	90	106	75
Slovnaft	Slovakia	Oil, gas	22.7	83	628	119
Zalakeramia	Hungary	Ceramics	60.7	69	39	2 022
Matador	Slovakia	Rubber, plastics	11.3	52	34	5
Malev Hungarian Airlines	Hungary	Transportation	32.4	43	274	49
KGHM Polska Miedz SA	Poland	Mining	8.6	34	265	25

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**Table 7. The largest non-financial TNCs from economies in transition, 1997-1999 (concluded)**  
(%, million dollars and number of employees)

Transnational corporation	Country	Industry	Transnationality		Foreign	
			index <sup>a</sup>	assets	sales	employment
Croatia Airlines	Croatia	Transportation	30.8	30	60	39
Elektrim SA	Poland	Conglomerate	2.2	21	42	62
Petrom SA National Oil	Romania	Oil, gas	3.7	19	211	67
Intereuropa	Slovenia	Trade	15.4	16	17	511
Other firms ranked among the 25 largest in 1997 and 1998						
VSZ Kosice (1998)	Slovakia	Steel industry	20.4	110	815	58
Graphisoft (1998)	Hungary	Software	85.3	28	25	188
Pilsner Urquell (1998)	Czech Republic	Beverages	8.8	20	16	356
Moldova Steel Works (1998)	Moldova	Steel industry	4.2	20	1	5
Budimex Capital Grp. (1998)	Poland	Building industry	29.3	18	56	644
Alrosa Co Ltd (1998)	Russian Federation	Diamonds	2.0	10	83	177
Lifosa (1998)	Lithuania	Chemicals	58.5	13	93	0
Norma (1998)	Estonia	Car industry	11.2	10	1	21
Alkaloid (1998)	Macedonia	Pharmaceuticals	14.3	1	25	58
Azovstal Iron & Steel (1998)	Ukraine	Steel industry	..	1	..	..
Iskraemeco (1997)	Slovenia	Electrical equipment	12.7	13	18	100
Agrimex Trading Co (1997)	Hungary	Trade	57.0	13	29	..
Dunapack Paper (1997)	Hungary	Wood, paper	4.3	13	2	41

Source: UNCTAD, 1999, 2000 and 2001.

<sup>a</sup> The transnationality index is the average of three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

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TNCs' behaviour in this industry. The holding based in Liberia, Latmar Holdings Corporation, monitors four Liberian affiliates, which together control 50 branches. Through its holding in Cyprus, Lasco holds two shipping companies and one financial trust. Last not least, Lasco controls a Baltic-Dutch shipping company, located in the Netherlands, the insurance company Kristaps in Bermuda and has a minority stake in Inmarsat Holdings Ltd (United Kingdom) and Morbank (Russian Federation). Eventually, Lasco relocated 98% of its assets abroad and, today, achieves 100% of its sales outside Latvia. Again this appears to be a transnational strategy, though specific to this industry.

### **An economic analysis of emerging TNCs from the East and the South**

The newly emerging TNCs from the East exhibit several characteristics that make them similar to Third World TNCs in the first stage of their expansion abroad. Therefore, those factors that have been identified in the literature for explaining the spread of Third World TNCs<sup>5</sup> are of high interest when analyzing TNCs that emerged in economies in transition.

#### *Common features of emerging TNCs*

Indeed, firms such as Daewoo, Petrobras, Hyundai, Embraer, Samsung, Tatung etc. (see the list of the 50 biggest TNCs from developing countries in UNCTAD, various years) have transformed themselves into fully-fledged TNCs today. They can be compared, to some extent, with western TNCs. Some TNCs from NIEs have reached a further stage of internationalization than those from economies in transition. One simple illustration of this is the transnationality index calculated by UNCTAD. Its value for the 25 biggest Eastern European TNCs – on average 32% in 1999 – was lower than the average

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<sup>5</sup> See, among others: Agarwal, 1985; Chudnovsky and Lopez, 2000; Dunning, 1986a, 1988a; Dunning and Narula, 1998; Heenan and Keegan, 1979; Khan, 1986; Kumar and McLeod, 1981; Lall, 1983; Lecraw, 1977; Tolentino, 1993; Wells, 1983; and Yeung, 1999.

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for the 50 largest Third World TNCs – 39% – and for the world’s 100 largest TNCs – 53% (UNCTAD, 2001). Considering the size of its foreign assets, one single TNC from an economy in transition (table 7), LUKoil, could be ranked among the 50 biggest Third World TNCs, where it would be fifteenth, right after Petrobras. Latvian Shipping, with foreign assets of \$459 million is still far from the fiftieth largest Third World TNC, Natsteel Limited (Singapore), which has \$585 million abroad. Finally, the cumulative foreign assets of the 25 biggest Third World TNCs reached 1.4% of the overall Third World GDP in 1997, whereas the cumulative foreign assets of the 25 biggest TNCs from economies in transition were only about 0.5% of the aggregated GDP of their home countries (UNCTAD, 1999). Therefore, Eastern European TNCs are in a nascent stage of internationalization. It is only when comparing the newly emerging TNCs in economies in transition today with Third World TNCs twenty years ago, that a number of common features emerge.

In the early 1980s, Third World TNCs were comparatively small. They had fewer foreign affiliates than Western TNCs. Their small-sized affiliates were in few host countries. TNCs from economies in transition share the same size characteristics today. Nevertheless, a few big Third World industrial groups had already been involved in outward FDI in the 1970s. In economies in transition as well, some big firms are leading outward FDI. Third World TNCs in the 1970s were basically undertaking South-South cross-investment in neighbouring countries, in the same region (Latin America, Asia). A similar strategy seems to be followed by CEE TNCs: they invest primarily in neighbouring economies in transition.

In Latin America, the small size of the domestic market is a factor, pushing local firms to invest abroad (Chudnovsky and Lopez, 2000). Indian outward FDI (Agarwal, 1985) was linked to export markets, showing that most Indian TNCs adopted a market-seeking strategy. Sanjaya Lall (1983) reported that outward FDI from developing countries was undertaken to supply foreign markets. UNCTAD (1997) suggested that

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Hungarian outward FDI was determined by the small size of the Hungarian economy and the good knowledge of Hungarian firms about market conditions in other economies in transition. Small-sized domestic markets are also a major reason for the transnationalization of Baltic firms (Liuhto and Jumpponen, 2001a) into neighbouring markets. Similar conclusions were derived from surveys of Slovene (Jaklic and Svetlicic, 2001) and Estonian firms (Varblane *et al.*, 2001). Lall (1983) also stressed that competitive pressures increased in the domestic market during a major inflow of FDI – exactly as in CEE countries – so that some local firms rather invested in less competitive markets abroad.

In a Slovene survey (Svetlicic, 1997), access to cheaper labour abroad was mentioned as a motive of outward FDI. This is a Slovene exception, due to Slovene unit labour costs, which are twice as high as in neighbouring economies in transition. Labour costs are not a determinant of Estonian outward FDI, according to the Urmas Varblane's survey (2001), particularly not so in the sector in which it is concentrated: in services. Efficiency has not been a major strategy of TNCs from economies in transition so far. The 25 biggest of them have a few employees abroad, even fewer than the 50 biggest Third World TNCs: 4.3% of their total employment for the former, 27.8% for the latter<sup>6</sup> (UNCTAD, 2000).

In Latin America, as well as in economies in transition, macroeconomic policies aimed at stabilizing the domestic economy and rising currency reserves facilitating outward FDI. Thereafter, economic recovery and growth perspectives of the domestic market pushed some Latin American firms to invest abroad. The same factors are at work in most economies in transition too. The acceleration of outward FDI coincides with the recovery of economic growth in the mid-1990s. In all former centrally planned economies, the supply side used to be highly concentrated and many firms were in a monopolistic or oligopolistic position in the domestic market. Even after a decade

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<sup>6</sup> The percentage is 51.5% for the world's 100 largest TNCs.

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of transition, this specific supply-side market structure is still in place. This compares with Latin American firms that have sometimes utilized their dominating position in the domestic market as a springboard for investing abroad. The parallel between Latin American and CEE emerging TNCs can be extended to common features in privatization, industrial restructuring and modernization that often preceded and triggered transnationalization.

In India, outward FDI was pushed (Agarwal, 1985) by such factors as stagnant domestic demand, high production costs in some industries at home, administrative restrictions that increased domestic investment costs and served as incentives to invest abroad, foreign exchange regulations and limited access to hard currency, and a dissuasive domestic level of taxation. Here a parallel can be drawn with Russian (and other CIS countries) outward FDI, since the domestic investment climate deteriorated for years (UNCTAD, 1999) due to some similar factors. Prohibitive domestic taxation, export quotas, political instability and high inflation, the illegal origin of capital and a willingness to have a foot in foreign markets explains most of the expansion of Russian TNCs abroad. Outward FDI from developing countries is more often determined by home, rather than host, country factors. The same observation is probably relevant as to the determinants of FDI undertaken by newly emerging TNCs from economies in transition.

***Analytical framework: outward FDI is determined by economic development***

In 1960, the outward FDI stock from developing countries had reached 1% of the world total, 3.2% in 1978. In 2000, this share had reached 11.9% if economies in transition (0.34%) are included in the developing world (UNCTAD, 2001). The growth of Third World TNCs proceeded in three stages (Dunning and Narula, 1998; Chudnovsky and Lopez, 2000). A first wave of FDI started from Latin America in the 1970s. New TNCs were emerging from Argentina, Mexico and Chile, and thereafter their Brazilian, Colombian and Venezuelan competitors invested

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abroad as well (Andreff, 1987). FDI was growing alongside an industrialization strategy based on import substitution in the home countries. Latin American TNCs were spreading abroad thanks to products that had met the needs of their growing domestic markets. Thus, outward FDI was primarily geared towards neighbouring developing countries in which a similar level of economic development was stimulating the demand for those products.

A second stage in the 1980s was dominated by Asian TNCs, spreading from the Republic of Korea, Taiwan Province of China, Hong Kong (China), Singapore and, thereafter, Malaysia, Thailand, China, India and Philippines. In this period, Latin American TNCs stepped back. Outward FDI from Asian NIEs accompanied their home country strategy of export promotion. Asian TNCs expanded mostly in the fast growing foreign markets of other NIEs, although they also invested in those developing countries that were less developed than their home countries (in order to benefit from cheap labour).

A third stage in the 1990s was characterized by a recovery of Latin American outward FDI in the context of global competition in manufacturing and services. The largest Asian TNCs at that stage already competed with western TNCs. Asian TNCs not only managed to invest in developed countries but also some of their home economies (Republic of Korea, Hong Kong (China), Taiwan Province of China) were becoming net FDI exporters, a position exclusively reserved to developed countries until recently. This sequence suggests, according to Daniel Chudnovsky and Andres Lopez (2000), that the assumption that outward FDI follows an IDP, first advocated by John H. Dunning (1981, 1986b, 1988a and b, 1993), and then referred to as such in the economic literature (Dunning and Narula, 1998; Narula and Wakelin, 1998; Chudnovsky and Lopez, 2000; Duran and Ubeda, 2001), is valid.

Four threads of analysis have attempted to explain Third World outward FDI. The first one (Lecraw, 1977; Wells, 1983; Agarwal, 1985) contended that TNCs from the South draw on

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specific advantages from implementing labour-intensive technologies and small-scale production, enabling them to compete in developed markets with cheap standardized products. This sort of advantage is derived from a home country's economic conditions since labour is cheap, firms are small-sized and their organization and management are less costly than the governance of TNCs from developed countries.

A second approach is at odds with the first one (Lall, 1983), because it contends that the Third World TNCs' expansion relies on competitive advantages linked to their specific technological, productive and commercial knowledge, such as more adapted technology and products that fit with price and quality requirements in other developing countries, more efficient small-scale technologies than those handled by TNCs from developed countries, production differentiated from that of large TNCs, and a better capacity to operate in a developing environment due to cultural, ethnical and linguistic factors. Lall challenged Louis Wells' idea that Third World TNCs would operate with a lower capital intensity than other TNCs. Their advantage is not embedded into an older (more labour-intensive) technology but results from all the technological changes they have been able to extract from their domestic technological basis. Home country characteristics push TNCs from the South to invest abroad rather than host country factors attracting their outward FDI.

A third approach (Tolentino, 1993) sought to explain outward FDI of the most advanced (Asian) Third World TNCs with the improvement of the NIEs' industrial structure. The latter results from the accumulation of technological competence acquired by firms alongside with the growth of their outward FDI. Asian TNCs are often independent from foreign technology, and their technological competence relies on learning by doing. Moreover, in a Schumpeterian evolutionary view of technological development, innovation in Third World TNCs is fuelled by industrial and technological development in their home countries, which itself favours an R&D effort within each firm, enabling it to handle and upgrade its own technology.

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The last approach attempted to synthesize the findings of the three previous schools by integrating them into a general theory (relevant for all TNCs and FDI in the world) under the name of the IDP. The IDP model is based on the assumptions that a country's inward and outward FDI is a function of its level of economic development (measured by its GDP per capita), and that a country undergoes a sequence of production internationalization alongside with its economic development. In stage 1, both inward and outward FDI are negligible. In stage 2, when a country starts industrializing, its domestic market widens and attracts inward FDI; a few outward FDI projects may appear; the balance of outward minus inward FDI is negative. In stage 3, technological competences improve, domestic demand for high-quality goods increases and the advantages for labour-intensive activities erode; the country becomes attractive to inward FDI; in addition, significant outward FDI develops on the basis of its specific innovations and international specialization; nevertheless, the outward-inward balance remains negative. Stages 4 and 5 apply to more developed countries. In stage 4, outward FDI outstrips inward FDI and the balance becomes positive (the Republic of Korea, Hong Kong (China) and Taiwan Province of China have recently reached this stage). Finally, in the most advanced countries, stage 5 is characterized by a very big volume of outward FDI plus very high inward FDI; these countries are likely to attain an unstable equilibrium around a zero FDI balance. According to Dunning (1993), the fifth stage represents the globalization of the most developed post-industrial economies of the world, explained by the dominance of services in GDP.

### **A test of the IDP model with emerging outward FDI from the East and the South**

In this article the IDP model is tested under the preliminary assumption that, as regards to FDI, economies in transition are somewhere between stages 1 and 3. The core explanatory variable should be GDP per capita. The level of economic development is completed with two other independent variables:

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- the sectoral distribution of the home-country GDP between agriculture, manufacturing and services, and
  - the technological level of production in the home country.

From the very beginning, there is a trade-off between maximizing the number of countries in the sample and responding to some of the criticisms addressed to traditional tests of the IDP model (Duran and Ubeda, 2001). The main objective here is to have an econometric testing as general as possible at the expense of using more sophisticated methodologies. The basic reason for this is that the IDP model is supposed to be relevant at the world level, including all TNCs and all home and host countries. Thus, a major constraint is data availability for the selected variables.

Some shortcomings pointed out by Juan J. Duran and Fernando Ubeda (2001) are avoided while achieving a partial test of the IDP model. What is tested here is only the outward FDI side of the IDP model.<sup>7</sup> Proceeding this way, criticisms as regards to the measurement of the outward-inward FDI balance are circumvented, as well as those issues involved in using FDI flow, instead of stock, data. Finally, two independent variables associated with the structural dimension of countries are tested, as suggested by Duran and Ubeda. These variables can categorize the 176 countries of the sample (that is the countries whose outward FDI stock data are available from UNCTAD) according to their structural similarities and differences.

The value of outward FDI stock per capita from all home countries is the dependent variable. The country sample contains 26 economies in transition, all developed countries and the bulk of developing countries. Two independent variables – GDP per capita and the sector-based distribution of GDP in the home country – capture both the level and the “model” of economic development in home countries. As to the sectoral variable, five

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<sup>7</sup> In a further study the inward FDI side and the FDI balance should be introduced after some methodological checks suggested in Duran and Ubeda (2001). For a preliminary test and analysis, see Andreff (2002).

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country categories are identified: developing countries in which agriculture dominates; economies in transition with a specific sectoral structure inherited from the planned economy phase (an excessive share of heavy industry in GDP and underdeveloped services); resource-rich countries (countries with high resource endowment such as oil, gas, raw materials) and financial centres, in which an exogenous element supersedes the development model; NIEs or emerging economies with both important manufacturing and services sectors; and post-industrial countries, with a predominant services sector.

A third independent variable is technology, differentiating between countries with a low level of development, high-technology countries and those countries at an intermediary level. Two variables are short-term or less structural: the exchange rate and GDP growth rate; they are introduced to control for a possible short-term impact (if any) in the IDP model and capture the possible effect of economic (stabilization) policy or fluctuations in home-country growth on outward FDI.

The estimation of an ordered logit model (Thomas, 2000) provides a qualitative test of both the quantitative and qualitative variables. Thus, the following cuts and categories are defined to transform the variables into categorical variables:

- Dependent variable:
  - o *outward FDI stock per capita* in 1998, FDI/cap: category 1: no outward FDI; category 2: \$ [0 , 100] ; category 3: \$ ]100 , 2000] ; category 4: > \$ 2000 (sources: UNCTAD and World Bank).
- Independent variables (data for 1998 except if defined otherwise):
  - o *GDP per capita*, GDP/cap: category 1: < \$ 600; category 2: \$ [600 , 2,000[ ; category 3: \$ [2,000 , 9,000] dollars; category 4: > \$ 9,000 (source: World Bank).
  - o *Sectoral distribution* of GDP, SECT (assessed from World Bank data), category 1: developing countries with agriculture > 40% of GDP and manufacturing

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- industry < 30%; category 2: economies in transition, defined as such, with the above-mentioned structure (even though it has evolved, the services industry being predominant now in Slovenia and Hungary); category 3: resource-rich countries and financial centres with an exogenous bias in the sectoral structure; category 4: NIEs with both manufacturing and the services sector over 40% of GDP; category 5: post-industrial countries with a preponderant services sector (> 60% of GDP).
  - o *Technological level, TECH*: category 1: low level with either < 100 researchers per 1 million inhabitants *or* < 5% high-technology exports in total export *or* < 10 patents registered by residents; category 3: high level with > 1,000 researchers per 1 million inhabitants *and* > 20% high-technology exports in total export *and* > 1,000 patents registered by residents; category 2: intermediary level, between category 1 and category 3; information only available for 1997 (source: World Bank).
  - o *GDP growth rate, g* : category 1: recession for  $g < 0\%$ ; category 2: stagnation or slow growth for  $g$  belonging to  $[0\% , 3\%]$ ; category 3: strong growth for  $g > 3\%$  (source: World Bank).
  - o *Exchange rate variation, DR* : category 1: depreciation for  $DR < - 2.5\%$ ; category 2: nearly stable rate of exchange for  $DR: [- 2.5\% , + 2.5\%]$ ; category 3: appreciation for  $DR > + 2.5\%$  (source: IMF).

Table 8 shows how the data are categorized for all variables.

Contrary to other variables that are ordered (although continuous, they are cut into categories),<sup>8</sup> the variable SECT has not the same characteristics and must be dichotomized for the ordered logit test. Category 1 has been chosen as the base

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<sup>8</sup> The model has also been tested with dichotomising each variable. The results remain the same.

category of SECT. In the light of the IDP model, the stock variable of outward FDI is meant to be better explained by structural (GDP/cap, SECT, TECH) than short term (g, D R) independent variables.

**Table 8. Distribution of observations by categories for each variable**  
(Number)

Category	FDI/cap 1998	GDP/cap 1998	TECH 1997	g 1998	DR 1998	SECT 1998	
Category 1	44	49	102	61	121	85	"developing"
Category 2	75	43	53	32	42	26	"transition"
Category 3	33	45	21	83	13	25	"resource-rich" and "financial centre"
Category 4	24	39				21	"NIE"
Category 5						19	"developed"
Total	176	176	176	176	176	176	

*Source:* the author's calculation.

Looking at the results (table 9), the value and the significance of the cuts confirm that the chosen categories of variables are relevant. It confirms the outward FDI side of the IDP model. The coefficient of GDP per capita shows that the probability for a country to move into an upper category is high when its level of economic development increases. This relation is significant at less than 1% (at 0.000 indeed, see table 9). *Outward FDI is nearly a function of the home country's level of economic development*, a relationship that applies to economies in transition as well.

As to the SECT variable, the probability for a country to move into an upper category of outward FDI is increasing if the country is graduating from the category of developing countries (or the economies in transition category in the case of CEE). The relationship is significant at 0% or nearly 0% in each case. *The sectoral structure of home countries is a strong determinant of outward FDI per capita*. Thus, for the time being, *economies*

*in transition are at an advantage in becoming a source of outward FDI*; they distinguish themselves even more from the NIEs in this respect. Indeed, the variable SECT shows that economies in transition differ from developing countries (which are in stage 1 of IDP model) as far as outward FDI per capita is concerned (significant at less than 1%, i.e. at 0.008). On the other hand, they differ more from developing countries than the NIEs do (which are in stage 3 of IDP model; this finding is significant at less than 1%). Taking these two results together, economies in transition as a whole appear to be somewhere between stages 1 and 3, mostly in stage 2 of IDP model, even though a few of them may individually be on the brink of stage 3 in 1998 (the so-called group 1 in table 4). Though rather interesting, such a conclusion has to be cautiously interpreted and opens avenues for further research covering also the inward side of IDP model and the IDP balance. It must be clear that, in economies in transition, it is not lagging industrialization, like in developing countries, that delays outward FDI, but the sectoral structure inherited from the former planned economy.

**Table 9. Ordered logit : independent variable, outward FDI stock per capita in 1998**

Explanatory variables	Standard Coefficient	error	t	Significance
GDP / capita 1998	1.0282	0.2256	4.558	0.000
SECT 1998, category 2 (transition)	1.5492	0.5835	2.655	0.008
SECT 1998, category 3 (resource-rich)	2.5613	0.6078	4.214	0.000
SECT 1998, category 4 (NIE)	2.4014	0.7455	3.221	0.001
SECT 1998, category 5 (developed)	5.5699	1.2599	4.421	0.000
TECH 1997	-0.2033	0.4516	-0.450	0.653
g 1998	0.0982	0.1852	0.531	0.596
D R 1998	0.6213	0.2753	2.257	0.024
cut 1	2.3214	0.7523	Number of obs.	176
cut 2	5.8643	0.9146	LR chi2 (9)	170.24
cut 3	8.6319	1.0653	Prob > chi2	0.0000
			Pseudo R2	0.3733

Source: the author's calculation.

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The technological level does not appear to be an explanatory factor as the others; the tested relationship is not significant. This may pave the way to further research *raising some doubt about the possibly exaggerated role given to technology* – whether imported, adapted or locally accumulated – in previous analyses of emerging Third World TNCs. This may be a lesson for economies in transition as well: domestic restructuring should be more important than importing updated technology, through FDI inflows or otherwise.

Outward FDI per capita is not determined by the GDP growth rate. This result is at odds with the contention of those economists and TNC managers who state that domestic growth fuels outward FDI. Therefore, explaining the expansion of outward FDI from economies in transition by the recovery of economic growth is not enough and must be completed by structural variables. Unexpectedly, the relationship between the variations of the home country's currency in the current year and the outward FDI stock per capita is significant at the usual threshold of 5%. The coefficient, though positive, has not a very high value. Nevertheless, the conclusion is that variations in the exchange rate influenced outward FDI in 1998. When moving up from category 1 (depreciation) to category 2 (stability) and then to category 3 (appreciation of the home country's currency), the probability increases for a country to belong to an upper category of outward FDI per capita. A positive relationship between an appreciating exchange rate and increasing outward FDI is the one postulated by economic theory, but it is very strong in one year – 1998 – in which many currencies were pushed downwards in the wake of the 1997 Asian financial crisis and then by the Russian financial crisis and the depreciation of the rouble (in particular in economies in transition). On the other hand, this relationship may explain why outward FDI from economies in transition did not proceed so much by means of M&As until 1998, and why this mode of entry started to develop after 1998.

The inherited structural features from the former planned economy still prevail in the economies in transition as determinants of outward FDI one decade after the onset of

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transition. This is the reason why these economies have not gone further than stage 2 of the IDP model.

### **Policy recommendations**

Sooner or later, most economies in transition will reach stage 3 of the IDP model, and the most advanced of them (the group 1 in table 4) may even expect to join stage 4 economies such as Taiwan Province of China and the Republic of Korea. An outward FDI policy must be designed to accompany this upstream move on the FDI development path – and it has as yet to be designed by those economies in transition that are the most advanced in this respect.

At the outset of the transformation process, strict control policies on capital outflows were justified on solid grounds: all economies in transition urgently needed to overcome balance-of-payments problems; they had to cope with foreign debt inherited from the former regime; they were lacking capital while their needs of economic restructuring were calling for significant domestic investment; in a number of economies in transition – in particular the Russian Federation and CIS countries – capital outflows were simply fuelling a massive capital flight that needed to be curbed; firms had used outward FDI either to escape restrictive regulations affecting their activity in the home country or to avoid new measures imposing a budget constraint. In some state-owned enterprises on the brink of privatization, managers formed so-called “by-pass” companies in order to strip the best assets abroad before privatization. With economic and institutional stabilization, this policy stance has been re-evaluated. Indeed, a number of economies in transition now permit or even encourage outward FDI.

The main policy recommendations that are listed below are already partially or fully implemented in some of the most advanced economies in transition. It would be worth adopting them as road maps in other economies in transition:

- Removal of all remaining restrictive outward FDI policy measures (authorization, permissions, prior approvals,

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provisions on foreign borrowing, taxes on remitted overseas income). Until now, Estonia and Latvia have gone the furthest on this path. Central Asian countries are lagging behind (and all group 3 countries as well). In a economy in transition, the removal of restrictions on outward FDI is a precondition for benefiting from a non-restricted inward FDI flow from neighbouring economies in transition.

- Abolition of the differential treatment between inward and outward FDI, and harmonization of FDI treatment with the EU; a must for those economies in transition that will join the EU in 2004, an advice for all other economies in transition once the importance of their bilateral FDI flows with EU members is taken into account.
- Consolidation of the two previous policy tools through the signing of as many double taxation treaties and bilateral investment treaties as possible. A lot has been done since the early 1990s, but economies in transition have focused on their main suppliers of inward FDI, i.e. basically the developed countries. Only Poland and the Czech Republic have developed a network of treaties with most economies in transition. The potential number of bilateral investment treaties (and double taxation treaties) among the 26 economies in transition is 650 (and 702 if Serbia-Montenegro is included). There is still a long way to go before all economies in transition will have signed such treaties with all countries located in the major area hosting their outward FDI, i.e. all other economies in transition.
- Outward FDI promotion, at least in the form of providing information and technical assistance to economies in transition' potential investors abroad. Since almost all economies in transition are now endowed with a FDI promotion agency (first looking for inward investors), this agency has the capacity to screen tax and fiscal incentives offered to foreign investors in various host countries, identify FDI opportunities abroad, conduct feasibility studies and even organize investment missions abroad and

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establish a database on investment opportunities. Meanwhile, until all restrictions are removed, the agency can operate as a “one-stop shop” for outward investors and assist them in obtaining the required approvals, permits, licenses and so on.

- Use of the guarantees of the Multilateral Investment Guarantee Agency (MIGA). Since almost all economies in transition are MIGA members, they can benefit from non-commercial (political) risk insurance provided to their outward investors in politically unstable countries (whose number is decreasing across economies in transition).
- Financial support and incentives: It is probably too early to consider outward FDI promotion from economies in transition in the form of financial support or providing fiscal incentives (tax exemptions). A return to the subsidization of enterprise operations may turn into a tricky political and economic issue in countries whose governments are committed to phase out as much of the former state interference in business as possible. A deeper economic analysis of the impact of outward FDI on the home country is needed before embarking on a policy that is costly and involves distortions. Nevertheless, in Hungary, the Government provides assistance to the country’s outward investors through the government-owned Corvinus International Investment Ltd., established in 1997, which supplies both finance (participation in share capital, loans and guarantees) and advisory services to potential outward investors, in particular medium-sized enterprises. An evaluation of the financial soundness and profitability of the prospective outward investor certainly is to be recommended, given the conditions of some firms in economies in transition. Hungary and Slovenia already proceed with some sort of screening (though in Slovenia the Ministry of Finance has not refused any application of an outward investor).

However, during the implementation of the above-suggested outward FDI policy, the watchword should be: do not rush! It

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must be kept in mind that the excess of inward over outward FDI in economies in transition has markedly cushioned the impact of a (still growing) foreign trade deficit on the balance of payments – except in the Russian Federation in which trade is in surplus. If an economy in transition reaches stage 4 of the IDP model (higher outward than inward FDI) before having solved its foreign trade problem – which means going further in economic restructuring and an upgraded international trade specialization – then it will have to face a worsening foreign debt constraint. On the other hand, becoming a home country for TNCs brings new international accountability with it. Economies in transition are used to check the behaviour of inward FDI in order to assess how much accountable they have been in terms of fair competition, economic restructuring, employment and compliance with other regulations. They will have now to face the complaints of host countries – namely other economies in transition – as regards to the behaviour of some of their outward-investing TNCs.

Finally, foreign policy interests also play a role in influencing outward FDI, at least from the Russian Federation. For instance, with a more active participation in global business, Russian TNCs can prepare the Russian economy for approaching World Trade Organization membership. Other views are sometimes expressed, especially in CIS countries, about the role of Russian TNCs, in particular in the oil and gas industries, where their dense network maintains newly independent States in a sort of economic dependency. In other words, since economies in transition are differentiated as FDI home countries, their future policies regarding their outward-investing TNCs will be – and already are – different.

### **Conclusion: the future of the newly emerging TNCs**

The newly emerging TNCs from economies in transition differ from the former “red multinationals”. In the framework of the IDP model, an ordered logit test shows that two structural independent variables are significant in explaining the outward FDI stock per capita from economies in transition, as well as

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from any home country in the world: the level of economic development of the home country and the sectoral structure of its GDP. However, the test differentiates the economies in transition from developing countries, both developing countries that are in stage 1 of the IDP model and the NIEs, which are in stage 3. TNCs from economies in transition, taken as a whole, are in stage 2. A follow-up to this study could explore separately the economies in transition that are likely to enter stage 3 of the IDP model – probably some countries in group 1— from the rest of the economies in transition. The technological level of a home country is not a significant determinant of outward FDI and is a less explanatory variable than usually assumed in the literature about Third World TNCs. Short-term variables basically were not expected to have a significant impact on outward FDI stock. The variation of the exchange rate nonetheless significantly influenced the outward FDI stock per capita in 1998.

What about the future of TNCs from economies in transition? As their home countries are about to reach stage 3 in the IDP model, the prospects are that their outward FDI will first expand in neighbouring economies in transition. Since wages and other production costs are rising in some economies in transition, an increasing share of their outward FDI should become efficiency seeking and, thus, geared towards low unit-labour-cost countries – those of group 3, together with Serbia and Montenegro, Viet Nam, Laos, Mongolia and other developing countries. This is exactly what happened with the relocation strategy of Asian NIE-based TNCs. The most promising prospect, however, is one of a more substantial FDI outflow from economies in transition to developed countries. Until now, this outflow has primarily concentrated in trade and services. If one refers to NIEs again, their manufacturing TNCs have been able to invest in developed countries since the mid-1980s. Investing abroad in developed countries should be the next step in the development of TNCs from economies in transition. Then, they will be on the verge of entering stage 4 of the IDP model.

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A specific forecast can be done for economies in transition with important natural resource endowments. The Russian Federation and Azerbaijan have been classified in group 1, basically due to their TNCs spreading abroad in the energy and raw material industries. Outward FDI will be boosted in these industries by M&As and strategic alliances with western TNCs, as it has already been done in the case of Gazprom. After the Russian Federation and Azerbaijan, Kazakhstan and Uzbekistan can be next on the list and, probably, Turkmenistan, if this country abandons its current isolationist economic policy.

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# RESEARCH NOTE

## Foreign aid, FDI and economic growth: evidence from Asian countries

Len J. Trevino and Kamal P. Upadhyaya \*

The relative effectiveness of foreign aid and foreign direct investment in five developing Asian countries (India, Indonesia, Nepal, the Philippines and Thailand) is examined in this research note. A model is developed to explain country-level aggregate output, including total labour force, capital stock, foreign aid, foreign direct investment, government expenditures and the real exchange rate. Pooled, annual time-series data from 1990-1999 are used to estimate the model. Before carrying out the estimation, the time series properties of the panel data are diagnosed and an error correction model is developed and estimated. Overall results suggest that both foreign aid and foreign direct investment have positively contributed to economic growth. However, the impact of foreign direct investment is greater than that of foreign aid in relatively open economies in the sample.

**Key words:** Asia, foreign direct investment; foreign aid; economic growth.

### Introduction

After World War II, and until recently, official development assistance (ODA) from developed countries was the principal source of external finance for developing countries. Foreign aid generally was intended to help alleviate poverty, to provide

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\* The authors are Partnership Society Associate Professor of International Business Strategy, Department of International Business, University of Southern Mississippi, Hattiesburg, MS, United States; and Associate Professor, Department of Economics and Finance, University of New Haven, West Haven, CT, United States; respectively. Correspondence: trevino@cba.usm.edu. The authors thank two anonymous referees for helpful comments on earlier drafts of this research note. The usual caveat applies.

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emergency relief, to assist with peacekeeping efforts and to increase infrastructural development. Recent shifts in the global economic and political environment, notably the collapse of the Soviet Union and the surge in private capital flows to developing countries, have impacted ODA in a way that has left some questioning the viability of foreign aid. In fact, foreign aid to developing countries declined by one-third in real terms in the 1990s (World Bank, 1998), perhaps because donor countries assume that it no longer achieves its desired objectives. With private capital flowing to developing countries at a record pace, increasing from \$43 billion in 1990 to approximately \$240 billion in 1999, and only recently pulling back under the weight of the early 2000s economic recession, it is often assumed that the importance of foreign aid has declined.

Whereas in the past, foreign direct investment (FDI) was seen as part of the problem in developing countries, due to assertions of exploitation, it is increasingly seen as part of the solution (UNCTAD, 1999b). In addition, favour-maximizing developed country governments may reduce foreign aid in response to increases in private capital flows. A change in the global economy, and in the way foreign aid is viewed by some, provides the rationale for this research note. The purpose of this study is to examine foreign aid and FDI in five developing Asian countries (India, Indonesia, Nepal, the Philippines and Thailand) in an effort to assess the relative effectiveness of FDI and foreign aid in contributing to economic growth in the host countries. These countries were selected because two are from South Asia (India, Nepal) and they are representative of that region. Likewise, the three East Asian countries (Indonesia, the Philippines and Thailand) in the sample are representative of the economic environment of that region.

## **Lessons from previous studies on foreign aid and FDI**

### ***Foreign aid***

There has been significant debate as to the effectiveness of foreign aid on economic development. In an early study, H.B. Chenery and A.M. Strout (1966) considered foreign aid as a

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factor that relaxes either the domestic saving constraint or the foreign exchange constraint, whichever is binding. According to them, foreign aid increases the rate of investment and the level of income in the economy by supplementing its available resources. K. Griffin and J.L. Enos (1970), however, argued that foreign aid does not contribute to economic growth, and that it fails to foster democratic political regimes.<sup>1</sup> Instead, foreign economic assistance could retard economic development by lowering the domestic savings rate. The authors tested this hypothesis using a bivariate regression model with cross-sectional data for 32 developing countries, and concluded that foreign aid inflows to developing countries caused the domestic savings rate to fall.

G. Papanek's (1973) conclusions are consistent with Griffin's and Enos' (1970) finding of a negative association between foreign aid and domestic savings, although he challenged their assertion of a causal relationship, with foreign aid leading to reduced domestic savings. According to Papanek (1973), a country receives more foreign aid during times of economic crisis, when the domestic savings rate is low. Therefore, the causality should run from the general economic condition, of which domestic savings is one indicator, to the inflow of foreign aid. P. Bowels (1987) applied a Granger causality test to this relationship, using annual data from 1960 to 1981 for 20 developing countries. His findings, however, were inconclusive, given that the nature and the direction of causality varied across countries. In addition, results for half of the sample countries did not show any causal relationship between savings and foreign aid.

To analyze the relationship between foreign aid and economic growth, some researchers have directly regressed foreign aid on the gross national product, with contradictory results. For example, Papanek (1973) found a positive and significant relationship between foreign aid and economic

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<sup>1</sup> See R. J. Barro (1997) for a discussion of the relationship between economic growth and the adoption of democracy, which he suggests is a *normal good*.

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growth, while C.S. Voivodas (1973) found a negative relationship between these two variables. P. Mosley, J. Hudson and S. Horrel (1987), using aggregate, cross-sectional data, reported a negative and significant relationship for the period 1960-1970, but a negative and insignificant relationship for the 1970-1980 and 1980-1983 timeframes. Recently, D. Dhakal, K.P. Upadhyaya and M.P. Upadhyay (1996) conducted a causality test between foreign aid and economic growth for four Asian and four African countries and found that, with the exception of Kenya and Nepal, foreign aid was positively and significantly related to economic growth.

Although P. Boone (1996) found that foreign aid did not increase growth rates for a typical poor country, C. Burnside and D. Dollar (2000) showed that, in poor countries with sound economic policies, aid accelerates economic growth. Conversely, the latter authors found that in highly distorted economies, aid is dissipated in unproductive government expenditures. This interpretation suggests that aid acts as an income transfer, which may or may not lead to growth. Burnside and Dollar (2000) suggested that the outcome depends on whether aid is used to finance capital investment or consumption expenditures. To the extent that aid is invested, it will be effective; to the extent that it is consumed, it will be ineffective.

### ***FDI***

During the past two decades, FDI has grown significantly more rapidly than either trade flows or foreign aid. One view of FDI is that it has important complementarities with the local economy, and therefore it stimulates development in the host country. The impact of FDI on growth is expected to be twofold. First, through capital accumulation in the host country, FDI is expected to increase economic growth by encouraging the incorporation of new inputs and foreign technologies in the production function of the host country (Dunning, 1993; Borensztein *et al.*, 1998). Second, FDI is expected to augment the level of knowledge in the host country through labour training and skill acquisition (De Mello, 1999).

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Capital-market disequilibrium theory suggests that capital in the form of private investment will flow to those countries where the risk-adjusted rate of return is the highest. Similar to Burnside and Dollar's (2000) study regarding foreign aid, it has recently been shown that inward FDI to economies in transition flows to those countries that have pursued market reform (Trevino, Daniels and Arbelaez, 2002). Through capital formation in the host economy, FDI is expected to be growth enhancing by encouraging the incorporation of new inputs and technologies in the host country. E. Borensztein, J. De Gregorio and J-W. Lee (1998) tested the effect of FDI on economic growth for 69 developing countries over two decades and found that FDI is an important vehicle for the transfer of technology, contributing more to growth than domestic investment. However, the authors found that FDI increases economic growth only when the level of education in the host country, a measure of its absorptive capacity, is high. Similarly, B.P. Bosworth and S.M. Collins (1999) conducted a comprehensive study on FDI, covering 58 developing countries from Latin America, Asia and Africa during 1978-1995. Their findings suggest that a one-dollar increase in capital inflow (all types) is associated with a fifty-cent increase in domestic investment. Separately, FDI appeared to bring about a one-for-one increase in domestic investment. Thus, FDI had a stronger impact on domestic investment than loans or portfolio investment. In a related study on the effect of FDI on total factor productivity growth, J. Ericsson and M. Irandoust (2000) found that FDI and output are causally related in the long run for Norway and Sweden.

### **Theoretical background, methodology and data**

The level of output in an economy is determined by the availability of factors of production. This can be expressed as follows:

$$Y = f ( K, L), \tag{1}$$

where Y denotes the output level (real gross domestic product (GDP)), K denotes the amount of capital, and L denotes the

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amount of labour. Assuming constant technology, any increase in the amount of labour and/or capital will increase the level of output in the economy. After adding foreign aid (FAID), foreign direct investment (FDI), government expenditure (GE), and the real exchange rate (RER) equation (1) can be written as:

$$Y = f ( K, L, FAID, FDI, GE, RER ) \quad (2)$$

In equation (2), it has been expected that the K and L coefficients, as measures of domestic capital and labour supply, respectively, be positively related to Y. Based on previous literature, the expected effect of foreign aid on the level of output is undetermined. Literature linking FDI to economic development is more consistent and this variable has been expected to have a positive effect on the level of output. Since government expenditures are expansionary, the “GE” (government expenditure) coefficient is expected to be positive. Recent studies have been inconclusive about the effect of the real exchange rate on the output of the economy. In general, it is assumed that currency depreciation improves the current account balance, which, in turn, increases the level of output in the economy. If this is the case, the “RER” (real exchange rate) variable carries a positive coefficient. However, R. Cooper (1971), and P. Krugman and L. Taylor (1978) argued that, if the demand for imported goods is inelastic, then currency depreciation may be contractionary. In addition, negative real balance- and supply-side effects stemming from exchange rate depreciation may reduce the level of output (Upadhyaya, 1999; Upadhyaya and Upadhyay, 1999; and Upadhyaya, Dhakal and Mixon, 2000). If this is the case, then “RER” may carry a negative coefficient.

The present study is based on panel data from five developing countries in Asia (India, Indonesia, Nepal, the Philippines and Thailand) and it covers the period 1990-1999. These countries have been selected because they have been examined (as a panel) extensively in the international and development economics literature (Upadhyaya and Upadhyay,

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1999; Upadhyaya, Mixon and Dhakal, 1999) and because there is significant variability in the macroeconomic factors as determinant independent variables and in FDI and foreign aid as dependent variables (definitions, measurements and sources of the data are reported in the appendix).

### Estimation of the model

Before carrying out the estimation of equation (2), the stationarity of the data series has been tested by conducting an augmented Dickey-Fuller test (Nelson and Plosser, 1982). This involved estimating the following regression and carrying out unit root tests:

$$\Delta X_t = \alpha + \rho_t + \beta X_{t-1} + \sum_{i=1}^n \lambda_i \Delta X_{t-i} + \varepsilon_t \quad (3)$$

In this equation,  $X$  is the variable under consideration,  $D$  is the first difference operator,  $t$  is a time trend, and  $e$  is a stationary random error term. Since the estimation in this research note uses panel data (Baltagi, 2001), before conducting the unit root test, the time-series aggregate effects are removed by subtracting the cross-country average from the original data (Heimonen, 1999). If the null hypothesis in equation (2), that  $b = 0$ , is not rejected, then the variable series contains a unit root and is non-stationary. The optimal lag length in the above equation has been identified by ensuring a white noise error term (i.e. an error term with a mean of zero, a constant variance and that is serially uncorrelated; see Enders, 1995). The Dickey-Fuller test has been supplemented with a Phillips-Perron test (Phillips, 1987; Phillips and Perron, 1988) for completeness (Mixon, Sawyer, and Upadhyaya, 2002). The Phillips-Perron test uses a non-parametric correction to deal with any correlation in the error terms. Both the Dickey-Fuller and the Phillips-Perron tests indicate that the data series are not stationary in level form (table 1). Therefore, these same tests have been performed on first differences. Table 1 indicates that all of the data series are stationary in first difference form. Thus, the regression, which follows, uses first-differenced data series.

**Table 1. Unit root test**

Variable	ADF		P- P	
	Level	FD	Level	FD
FAID	-1.72	-3.81**	-2.12	-7.39***
FDI	-4.68***	-7.72***	-3.14	-5.36***
GE	-1.64	6.03***	-3.09	-10.05***
K	-0.94	-5.10***	-2.47	-10.06***
L	-1.67	-5.11***	-1.71	-7.34***
RER	-2.79	-5.14***	-2.25	-5.13***
Y	-1.71	-5.54***	-2.87	-9.42***

*Source:* Authors' calculation.

*Note:* \*\* rejection of hypothesis at 5 % level,

\*\*\* rejection of hypothesis at 1 % level.

Critical values derived from MacKinnon (1990).

After establishing the stationarity of the differenced data series, a Johansen cointegration test (Johansen 1988, Johansen and Juselius, 1990) has been employed to examine the long-run equilibrium relationship between the variables used in the model. This has involved testing the number of cointegrating vectors; the test results are reported in table 2. Test statistics in table 2 suggest that the null hypothesis of “no cointegration” is rejected.

**Table 2. Johansen's cointegration test**

H	Eigenvalue	Likelihood ratio	5% critical value	1% critical value
$r \leq 0$	0.941	295.49**	124.4	133.57
$r \leq 1$	0.659	159.77**	94.15	103.18
$r \leq 2$	0.613	108.19**	68.52	76.07
$r \leq 3$	0.476	62.59**	47.21	54.46
$r \leq 4$	0.375	31.61*	29.68	35.65
$r \leq 5$	0.121	9.01	15.41	20.04
$r \leq 6$	0.057	2.83	3.76	6.65

*Source:* Authors' calculation.

*Notes:* \*\* rejection of null hypothesis at 1% level, \* rejection of hypothesis at 5% level.

Since pooled, time series data from different countries have been used, panel cointegration tests also have been conducted, as suggested by P. Pedroni (1999). The calculated panel  $t$  statistic was found to be  $-5.791$ , which is greater than the critical value (in absolute terms) at the 99% confidence level. This confirms that the variables in the model are cointegrated. Therefore, following R. Engle and C. Granger (1987), an error correction model has been developed. This model is:

$$\Delta Y = b_0 + b_1 \Delta K + b_2 \Delta L + b_3 \Delta FAID + b_4 \Delta FDI + b_5 \Delta RER + b_6 \Delta GE + b_7 EC_{-1} + v \quad (4)$$

In equation (4),  $EC_{-1}$  is the error correction term, or the lag of the estimated error term from equation (1) and  $v$  is the random error term.

The regression estimate of equation (4) is as follows:

$$\Delta Y = 882.96 + 0.18\Delta K + 0.05\Delta L + 2.15\Delta FAID + 2.50\Delta FDI + 5.08\Delta GE - 5.32\Delta RER - 0.34EC_{-1} \quad (5)$$

(1.08) (0.809) (2.008)\*\* (1.736)\* (1.97)\*\* (13.42)\*\*\* (4.781)\*\*\* (3.497)\*\*\*

$$Adj R^2 = 0.98 \quad D.W. = 2.168 \quad Breusch-Godfrey = 1.88 \quad F = 290.61 \quad RESET F = 1.93 \quad n=49$$

*Note:* Figures in the parentheses are  $t$ - values of the corresponding coefficients, where \*\*\* denotes significance at the 1% level, \*\* significance at the 5% level and \* significance at the 10% level.

The estimated result reported in equation (5) seems to be consistent in terms of the coefficient of determination, the Durbin-Watson test, and the F-Statistics. The calculated value of the Breusch-Godfrey test statistic is statistically insignificant, which further insures the absence of serial correlation (Kennedy, 1998). Likewise, the statistically insignificant *RESET-F* statistic indicates absence of any possibility of specification error in terms of either missing regressors or non-linearity (Kennedy, 1998).

## Results and discussion

In equation (5), of those independent variables that carried *a priori* hypotheses (i.e. K, L, GE and FDI), all had theoretically expected signs, although not all are statistically significant. The coefficient of capital (K), though positive, is not significantly

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different from zero, whereas the coefficient of labour (L) is positive and statistically significant. As expected, the GE coefficient is positive and statistically significant. The RER coefficient, for which there has not been an *a priori* expectation, is negative and statistically significant. On the one hand, currency devaluation is generally thought to improve the overall terms of trade, leading to an improvement in the country's trade balance, thus expanding aggregate output and employment. Others argue that devaluation may lead to a negative real balance effect, resulting in lower levels of aggregate demand and output. The results in this research note are consistent with this second line of reasoning (see Upadhyaya, 1999; Upadhyaya and Upadhyay, 1999; Upadhyaya, Dhakal and Mixon, 2000).

The focus of this study, however, is on the coefficients for foreign aid (FAID) and FDI. The present study finds both the FAID and FDI coefficients to be positive and statistically significant. In a separate test, using the results of the regression equation above, the difference between the coefficients of the two primary regressors (FAID and FDI) is tested.<sup>2</sup> The null hypothesis (i.e. that the FDI parameter is less than or equal to the FAID parameter) is not rejected (at the .10 level or better for a one-tailed test).<sup>3</sup> This result suggests that, at the margin, the impact on GDP from an increase in FDI is not significantly greater than the impact on GDP from an increase in FAID, at least for the countries under study. When a dummy variable for the three countries most open to inward FDI (Malaysia, the Philippines, Thailand) is included in the regression, the difference between the FAID and FDI regressors grows to 0.71 (in favour of FDI) and this difference is significant at the 95% confidence level.<sup>4</sup> This difference suggests that, for these

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<sup>2</sup> Based on the previous literature detailed above, this test is set up as:

$$H_0: B_{FDI} \leq B_{FAID}$$
$$H_1: B_{FDI} > B_{FAID}$$

<sup>3</sup> The difference between the FDI and FAID coefficients is 0.35 (in favour of FDI, as expected). This difference, however, is significant at the 0.42 level only.

<sup>4</sup> In this model, the FAID parameter is 2.25 and the FDI parameter is 2.96. Both of these are significant at the 0.05 level.

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countries, an additional dollar of FDI will have a \$0.71 greater contribution to real GDP than will an additional dollar of foreign aid. However, similar to W. Easterly, R. Levine and D. Roodman (2003), it is not argued in this research note that aid is ineffective. The findings are consistent with those of Burnside and Dollar (2000), in which the authors found that foreign aid can lead to economic growth in countries with good economic policies. However, this research note extends extant literature because, in contrast to the Burnside and Dollar (2000) study, FDI has been added to the equation and it has been found that FDI can be more effective than foreign aid in countries with these same conditions.

The findings of this research note on capital and labour may result from the fact that the countries under study tend to produce mostly labour-intensive goods. Under these circumstances, the labour coefficient is significant and the capital coefficient may be statistically insignificant. Additionally, the size/significance of the FDI coefficient relative to that for capital (which is insignificant) is interesting. The FDI coefficient (2.50) is statistically greater than the capital coefficient (0.18) at the 0.041 level. This finding supports Borensztein *et al.* (1998), who concluded that FDI, as an important vehicle for technology transfer, contributed *more* to economic growth than domestic investment. The robustness of their general conclusion holds for a subset of their sample (Baltagi, 1999).

Economic growth in developing countries depends on many factors, including internal economic conditions, as well as such external factors as FDI, portfolio investment and foreign aid. All of these external factors depend on internal economic policies, such as institutional and macroeconomic reforms designed to stabilize the economy. Since there is a marked trend towards better policy among poor countries, the climate for effective aid is improving (Burnside and Dollar, 2000).

Although the results of this research note are consistent with those of Burnside and Dollar (2000), our findings regarding the difference between foreign aid and FDI, in favour of FDI, likely stem from policy differences in the countries under study.

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While all of the countries studied can be classified as developing, there are differences in these countries in terms of income, politics and local infrastructure. Thus, the results of this research note concerning the magnitude of the FAID and FDI parameters are not surprising.

Government officials in developing countries also acknowledge that they need outside capital to achieve their growth objectives, and, increasingly, this outside capital comes from FDI. Between 1991 and 1998, the share of FDI in total capital flows to developing economies increased from 28% to 56% (UNCTAD, 1999a). This change occurred because of decreases in government-to-government capital transfers. These transfers have been affected by fewer political imperatives since the end of the Cold War, disillusionment in industrial countries about the positive effects of foreign aid on development, and growing preferences by donors to shift foreign aid to help with disasters rather than with economic development.

At the same time, host governments have become more interested in receiving private outside capital in the form of FDI rather than in portfolio flows (loans and short-term investments). This is because portfolio flows are more volatile than FDI flows. Additionally, host governments realize that private companies hold resources other than capital that can aid their development, such as technology, human resource training capabilities, and access to foreign markets.

However, companies are reluctant to transfer these resources to countries that limit their ownership of the facilities that will use them (Moran, 1998), so governments now encourage FDI. An interesting and surprising finding of the present study is that foreign aid may actually act as a complement, or even as a catalyst to foreign direct investment. Since foreign aid has been shown to increase economic growth and to help with the development of local infrastructure, for countries committed to market reform, foreign aid may actually increase foreign investors' confidence. Concomitantly, this may bring about increased levels of FDI.

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## Summary and conclusion

This research note has examined the effectiveness of foreign aid and FDI in five developing Asian countries (India, Indonesia, Nepal, Philippines and Thailand). The model includes total labour force, capital stock, foreign aid, FDI, government expenditure and the real exchange rate to explain the output level. To estimate the model, pooled, annual time series data from 1990-1999 are used. Before carrying out the estimation, the time series properties of the panel data are diagnosed and an error correction model is developed and estimated. Overall results indicate that both foreign aid and FDI have positively contributed to economic growth, but that the impact of FDI is greater than that of foreign aid for relatively open economies in the sample. Results of this study support past empirical work by suggesting that both foreign aid and FDI play a positive role in economic growth and development. In an attempt to develop this literature, future studies might focus on generalizing this work by increasing the geographic region of countries under study. Perhaps a more important area for future research would be to study the effectiveness of foreign aid by examining more closely its interactions with other exogenous variables, such as domestic savings, balance of payments, and FDI. This suggestion is consistent with a recent study (Teboul and Moustier, 2001) in which the authors found that aid efficiency is indirect and dependent on the way it is transmitted via exogenous variables. This is in line with the proposition of this research note that foreign aid may act as a catalyst for FDI, especially in those countries with supportive economic policies and effective market reform. ■

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## Appendix

All the data are in real terms (at 1995 constant price).

**Capital:** Gross fixed capital formation, measured in millions of \$, annually, 1990-1999. Source: *International Financial Statistics*.

**Labour:** Economically active population, measured in thousands, annually, 1990-1999. Source: *International Financial Statistics*.

**Real Exchange Rate:** (Nominal exchange rate)\*(World Price Index/Domestic Price), annually, 1990-1999. Source: *International Financial Statistics*.

**GDP:** Host country gross domestic product, measured in \$ million, annually, 1990-1999. Source: *International Financial Statistics*.

**Government Expenditure:** Total government expenditures, measured in \$ million, annually, 1990-1999. Source: *International Financial Statistics*.

**Foreign Aid:** Inward foreign aid for each recipient country, measured in \$ million, 1990-1999. Source: *International Financial Statistics*.

**Foreign Direct Investment:** Inward foreign direct investment for each host country, measured in \$ million, 1990-1999.

Source: *International Financial Statistics*.



## BOOK REVIEW

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### *Globalization of Services: Some Implications for Theory and Practice*

Yair Aharoni and Lilach Nachum, editors  
(London and New York, Routledge, 2000), 338 pages

In *Globalization of Services: Some Implications for Theory and Practice*, Aharoni and Nachum examine the reasons service firms expand into the international arena: what is their motivation for such expansion, when do firms internationalize and how? This book is highly informative and responsive to John H. Dunning's observation in the early 1990s "that a lacunae exists in the repertoire of IB scholar seeking to explain the growth of FDI in services" (Dunning, 1993, p. 243). The book first summarizes trends related to foreign direct investment (FDI) in services and the institutional environment in which these transactions take place, then presents theoretical contributions on services and concludes with case studies of internationalization of services in different industries. It provides both a sound foundation for future research in this area as well as a realization that the international business literature has only just begun to address the question of the globalization of service industries, compared to studies of manufacturing, and that additional research is sorely needed to explain the phenomenal growth of international activities in services in both developed and developing countries.

The editors are well suited for the task, bringing a wealth of international business experience to this task. They have assembled a geographically diverse set of researchers from ten different countries. This diversity adds immensely to the breadth and depth of the topics covered.

The book will be of greatest interest to two different audiences: first international business scholars who attempt to develop models to test theories in the rather amorphous, dynamic, tacit, but increasingly important world of services.

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The second group are researchers who attempt to create new sources of data, primarily based on cases and data collected by the Government of the United States. If the proportion of academic research is to come anywhere close to the relative importance of services in the world economy, a tremendous effort is required in both data collection, theory development and modelling. This book provides a foundation for further research in these areas.

The major point of departure is the belief that what one has learned from the study of FDI in manufacturing firms cannot be blindly applied to service industries. Even within the services sector, there are many different types of industries that require separate streams of analysis. The study of the government-constrained airline industry is dramatically different from the footloose, knowledge-intensive management consulting business. It appears that reputation has a more central role in the consumer evaluation of service firms because of the intangible nature of the product and its inability to be evaluated before, during or in many cases well after delivery.

This edited volume consists of 15 chapters organized around three parts: the globalization of services, theory and case studies. More specifically, part I summarizes *trends related to FDI* in services and how the institutional environment affects these transitions. In chapter 2, two senior UNCTAD economists, Padma Mallampally and Zbigniew Zimny, undertake a tremendous data collection effort and present a wealth of historical FDI stock data for sectors and countries, all indicating the increasing importance of services FDI in the globalization of economic activity; for example, services FDI accounted for 25% of the total FDI stock at the beginning of 1970 and almost half the stock in 1995. Key reasons cited for this growth include economic growth, structural change, liberalization of foreign entry and operations policies, and the increase of specific competitive advantages of transnational corporations (TNCs) based on technological, managerial, financial, marketing, or organizational knowledge. The authors make the interesting and important point (picked-up in subsequent chapters) that the growing tradability of information-intensive services is

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generating scope for efficiency-seeking and creative asset seeking FDI, extending the inducements beyond those related to the quest for markets.

Dale B. Honeck in chapter 3 highlights the need for regulatory discipline in professional services. The efforts of supra-national organizations such as attempted by the World Trade Organization (WTO) through Article VI of the General Agreement on Trade in Services and the Working Party on Professional Services to reduce the maze of regulation that have severely handicapped the trade in professional services are well documented. The goal of these organizations is to ensure greater transparency, predictability and irreversibility of policies for both trading partners and domestic producers. The WTO can give legal enforceability to these measures and has made the most progress of any government-led international organization, but much is required before full benefits of regulatory transparency can be realized in this area.

The “*Theory*” section of the book begins with a chapter by Nachum that examines the implications of foreign activities by TNCs for the link between the location advantages of home countries and the competitiveness of firms. Her quantitative analysis finds that FDI weakens the link between the location advantages of home countries and the ownership advantage of firms, which tend to be strong when firms operate only or mainly within their home countries. Her study of United States inward and outward FDI in professional service industries reveals that the majority of foreign activities are of market-seeking type, require deep knowledge of the local market and are somewhat more independent because of the institutional-based structure constraint of partnerships. She points out that certain characteristics of the United States limit the validity of the findings for other countries.

David J. Cooper, Teresa Rose, Royston Greenwood and Robert Hinnings highlight the importance of history and contingency theory in the evolution of the accounting industry in global business. The authors begin with a contingency framework explanation, i.e. there is a best way to organize, dependent on environment conditions, scale and the task, and then use case studies of Andersen Worldwide and KPGM to

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refute these assertions. Even given the same institutional environment, accounting firms differ historically on several key dimensions, learned expertise, governance, design, domain and critical decisions, and/or cultural origins. The authors take one parting shot at contingency theory by stating that international arrangements need to be seen and studied more as processes than as immobile structures aligned to environmental characteristics. They conclude by stating that we need to organize our interpretations of the social experiences of these firms, over time, in dynamic instead of structural ways.

In the chapter by Aharoni, he asks an interesting question: why are there some very successful global operators in professional business services (e.g. legal, consulting) – services that are highly dependent on the skills of the individuals, with little or no economies of scale or of scope, and few possibilities of standardization – while thousands of others continue to confine their services to one nation or region. Specifically, he focuses his analysis on the role that reputation plays in an uncertain world. He asserts that the higher the perceived differentiation of a service, the greater the saliency of perceived quality and reputation. The more complex the service and the more it is based on unique knowledge, the more difficult it is for the customer to assess quality. Aharoni concludes that the combination of the difficulty of judging quality and the crucial importance of outcomes makes reputation extremely valuable. Aharoni indicates that, under certain conditions, professional business service TNCs do transfer reputation, but this is contingent upon the ability of a firm to convert individual ability into a firm asset. He finds reputation is becoming a proxy for quality, and reputation itself is judged by such factors as the size of the firm, its clients or *pro bono* work.

Bente R. Lowendahl takes a slightly different approach in her chapter, focussing her analysis specifically on knowledge intensive professional service firms, i.e. firms that deliver client-tailored services based on a careful and ethically sound professional judgement. The bulk of their earnings is based on the application of their expertise in either a fixed fee or agreed upon hours to complete the task. Delivery usually requires a

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high degree of interaction and services are constrained by professional norms. Opportunism is typically linked to defining a more complex problem than necessary and/or increasing the work-hours required. Success factors for firms in these industries include: selling a credible promise, delivering on what is promised and learning from the selling and delivering process to increase future efficiency and effectiveness. The main reason for these firms to globalize is likely to follow the globalization process of the buyers of their services. This in turn has a positive valence because clients view size and global presence as indicators of quality and reputation. Whether or not a physical presence is required in a foreign location is largely determined by duration and frequency of client demand. Co-ordinations of seamless products and diseconomies of scale, multiple sites, languages and cultures also limit foreign expansion.

Martin Kretschmer, Charles Baden-Fuller, Georg Michael Klimis and Roger Wallis highlight the important point that globalization has intensified the challenge to codify naturally proliferating “intangibles” into tradable goods, and simultaneously to keep sensitive resources from the reach of the market by deeply embedding them into processes. They provide a detailed look at the global music industry and the problems and opportunities associated with the digitization of music and the Internet. As part of this analysis, they identify the complex institutional process involved, and examine the current, and likely future, nature of intellectual property rights in the global music business. They conclude that the resolution of the array of intellectual property issues facing the music industry will most certainly have far-reaching implications for how we think about the knowledge economy.

Karin Fladmoe-Lindquist notes that global franchising involves a complex web of relationships that has become a significant form of FDI in services. The discussed network approach to franchising is based on linkages and relationships that share knowledge and create flexible routines that are difficult for competitors to replicate. The networked culture helps identify potential opportunities, formulate agreements and coordinate and adapt actions and linkages necessary to gain access to international resources. As with Kretschmer *et al.* and

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Aharoni, the image and reputation that result from the shared identity serves to attract potential franchisee inquiries regarding business and partnership opportunities. The four key aspects of network theory are central to franchising, namely, shared sense of identity, collective learning, franchise partner stats, and the role of franchise network culture. Specifically they facilitate access to resources, ideas and partners that might otherwise be difficult to gain.

In the chapter on “Knowledge creation and transfer in global service industries” Robert Grosse’s basic premises are that the knowledge-transfer process is the key competitive advantage and service industries’ value-chains imply greater interaction than those of manufacturing industries. He observes that, because service firms depend so heavily on interaction with clients, as well as on the brainpower of their employees, they must develop organizational processes that guard against employee raiding and other turnover. The team approach with geographically dispersed areas of specialization is one such operating mode for consultant and advertising services. Teams and historically based relationships are with the firm rather than the individual as such and are therefore less likely to be expropriated. Grosse observes that the globalization of services is much more a recent activity than that of manufacturing, but in both cases export and alliances usually precedes FDI. However, global service firms appear to experience fewer entry barriers in setting up full-service operations than typically occurs for manufacturing firms.

The last section provides five interesting *case studies* in three areas: airlines, lodging and package distribution. Tan Kim Seng and Peter Enderwick indicate that, for aircraft maintenance, the globalization of markets and the introduction of new technology are causing major changes in industry structures and the sources of competitive advantages. They observe that outsourcing has increased rapidly throughout the industry and has changed from being a contract or a job to a partnership with a service provider in which both must strive to achieve operational excellence. Service providers are increasingly moving closer to customers and have shifted their focus from

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provision of warranties to managing the total cost of engine ownership.

The case study prepared by Hannu Seristö dubs the 1990s as the decade of alliances. Governments in their attempt to balance the desire to have an efficient global airline industry with their desire to have sufficient regulation to ensure competition have blocked the natural evolution towards TNCs. Industry players believe that governments around the world have created an alliance structure that appears to be an artificial solution to an artificial problem. Airlines seek international competitiveness through alliances; over 90% of airline alliances involve no equity, and less than 30% of them are viewed to be successful by their partners. Seristö indicates that the airline industry's basic problems are quite similar to those of the telecommunications industry.

Unlike airlines for which governments determine the rules of global competition, Michel Kostecki in his chapter discusses how idiosyncratic government practices in the package handling business have created a business niche for DHL. To wade efficiently through local laws, DHL has a local customer service department in every major country. Technology-driven trading systems have the potential to streamline operations significantly; however, each sovereign territory's local needs and concerns take priority over global preferences, or the interests of companies operating in global markets.

Farok J. Contractor's and Sumit K. Kundu's study examines the global spread, strategies and foreign operation modes of hotel firms. Their key conclusions are that contractual relationships (alliances) can effectively substitute for equity ownership when key strategic variables (reservation systems, operating processes) can be codified and fear of opportunism can be reduced by the global company's ongoing control over strategic assets (brand and reputation).

The last of the cases, the French hotel Novotel by Susan Segal-Horn, traces the process of identifying, developing and rebuilding core competencies over a 30-year period. In the 1970s and 1980s, Novotel embarked on a standardization strategy that

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was robust enough to survive transferability across borders and generate consistent service standards to satisfy customer expectations, irrespective of local conditions, local culture or local infrastructure. Over time these routines by Novotel were copied; in the early 1990s, it chose to redefine its basic value system. More specifically, in an attempt to create distinctive competences and mitigate imitation, information flows were recast to enable linkages, collaboration was emphasized with headquarters becoming a co-ordinator, working methods were broadened leading to multi-tasking and multi-competences. Novotel was able to implement a new strategy that simultaneously increased customer responsiveness, organizational cohesion and technical competence.

The bottom line: the book provides a wealth of information in an increasingly important FDI area, the globalization of services. It does so in an interesting mix of theory and case chapters, each highlighting a different vector that bounds the highly diverse market-space associated with the provision of global services. Many of the authors highlight the importance of “reputation” in the provision of services; however, there appears to be little empirical work on this key global differentiator. This reviewer would encourage researchers to go beyond case studies and begin testing some of the precepts associated with new organizational forms not present in manufacturing industries, such as network relationships in knowledge intensive businesses and the gaining of competitive advantage among and between domestic and international service providers.

**Cliff Wymbys**

Assistant Professor, International Business  
Baruch College, The City University of New York  
New York, United States

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***East Goes West: The Internationalization of Eastern Enterprises***

Kari Liuhto, editor  
(Lappeenranta, Lappeenranta University of Technology, 2001),  
467 pages

***The Russian Eagle Has Landed Abroad: Evidence Concerning Foreign Operations of Russia's 100 Biggest Exporters and Banks***

Kari Liuhto and Jari Jumpponen  
(Lappeenranta, Lappeenranta University of Technology, 2003),  
143 pages

*East Goes West* contains 17 chapters written by 20 authors from Estonia, Finland, Hungary, Latvia and the Russian Federation. All of them examine the increasing internationalization of enterprises from Central and Eastern Europe (CEE), with a focus on their outward foreign direct investment (FDI). The analysis starts with three case studies on the biggest Russian gas and oil companies, such as Gazprom and Lukoil. In the first chapter, by Kari Liuhto, the REM (“reason-environment-modal choice”) model is used to identify:

- the main reasons for the internationalization of those natural-resource majors, namely: internationally competitive products, a growing world demand for those products, a huge price gap between the Russian and world markets, tax considerations and, in some cases, the influence of foreign shareholders;
- the selection of their target countries, namely: post-socialist economies, the European Union (EU) and the United States;
- and their choice of mode of internationalization: a complex one.

The influence of the Government of the Russian Federation on the activities of these companies is justly regarded as one of the main peculiarities of outward FDI from the Russian Federation, although this influence is exaggerated sometimes.

The second chapter, by Andreas Heinrich on Gazprom, analyzes the implications of the institutional environment for

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business operations of Russian companies on foreign markets and concludes that "...*Gazprom* pursues two completely different strategies at its different levels of action. At the international level, the company aims at further integration into a globalising world economy. At the CIS [Commonwealth of Independent States] level, however, it tries to preserve regulated and hierarchical markets..." (p. 82). The fresh contract (April 2003) of *Gazprom* with Turkmenistan for the exclusive purchase of Turkmen natural gas in the next 25 years looks like an additional proof of this thesis. The analysis of *Lukoil* and other leading oil firms in the third chapter also confirms that the domestic and international price difference is a mighty motive for the internationalization of Russian oil industry. Another six empirical case studies on Russian business abroad deal with electricity, aluminium, pulp and paper industries, as well as with the international business of the Pulkovo airport (Moscow region) and Russian businesses in Finland.

The four chapters on Estonian firms' operations abroad rightly emphasize that in that country a substantial part of inward FDI transforms to outward FDI. About 70% of the inward stock of Estonia is from Sweden and Finland and a quarter of this stock is concentrated in finance (pp. 245-246). As a result, non-residents (especially Scandinavian banks) own 84% of the shares of Estonian commercial banks (p. 343). They regard Estonia as a first step on a Baltic staircase. The second step is the outward FDI of their Estonian banking affiliates in neighbouring countries: 85% of Estonia's outward stock goes to Latvia and Lithuania, and 61% of this stock is in finance (pp. 248-249).

Liuhto's chapter about the Latvian Shipping Company analyzes an impressive example of asset emigration that formally looks like internationalization. The demise of the Soviet Union brought its Baltic merchant fleet registered at Latvian ports into the hands of independent Latvia. Eventually 98% of the Latvian Shipping Company's assets (\$0.5 billion) went abroad to affiliates in Liberia, Malta and Cyprus to obtain flags of convenience, resulting in cost reduction and less taxes. The last three chapters describe the internationalization of Slovenian and Hungarian companies. It is interesting to read about the "forced internationalisation" (p. 386) of many Slovenian companies (as the author, Andreja Jaklic coined the phenomenon), consisting

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of establishing new affiliates in the other former Yugoslav republics in order to keep these traditional markets. To a lesser extent, this is the case of Hungarian companies, too, especially of the Hungarian Oil and Gas Company (the biggest Hungarian firm) with its four foreign affiliates in adjacent countries and substantial oil reserves in the Russian Federation and other countries.

*The Russian Eagle Has Landed Abroad* focuses on Russian TNCs only. It responds to the following questions:

1. How much have Russian firms actually invested abroad?
2. What are the main target countries?
3. Which are the biggest outward investing Russian companies?
4. What does this outward expansion mean for the Western economies and their relations with the Russian Federation?

The answer to the first question is \$14.4 billion at the beginning of 2002. This UNCTAD estimate cited by Liuhto and Jari Jumpponen (p. 9) is very close to the Central Bank of Russia's latest figure: \$14.7 billion ([www.cbr.ru/statistics](http://www.cbr.ru/statistics)). However, \$14-15 billion is rather a conservative estimate because it does not cover capital flight, which is the dominant way of the Russian Federation's capital outflow.

In response to the second and third questions, the authors indicates that the main target countries of Russian outward FDI are other transition economies (25%), EU (31%) and the United States (23%) (p. 12), and the leading capital exporting companies of the Russian Federation are oil and gas firms. A combination of big profits generated abroad thanks to high world prices (the Russian oil and gas industry's profitability reached 23.3% in 2000), of a low profitability of internal-market oriented activities (in mechanical engineering, profitability reached 5.4% only in the same year) and monopolistic hurdles inside the Russian Federation stimulated the Russian oil and gas barons' FDI into the neighbouring countries. At the same time, the huge capital flight from the Russian Federation can be deducted from the prominence of offshore centres (European, Caribbean and Pacific alike) on the list of target countries. The capital flight component of Russian outward FDI has been so far insufficiently

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analyzed, due to the weaknesses of classical capital flight theory that fails to provide a satisfactory set of professional tools to analysts. Very probably, the main motives of current Russian capital flight have little to do with internationalization (or regionalization, or globalization); they may be closer to tax reduction and profit relocation (similar conclusions were drawn in the above-mentioned study on the Latvian Shipping Company).

Answering the last question, the authors conclude their analysis with two extreme scenarios:

1. globalizing the Russian Federation; and
2. blocalizing the Russian Federation.

The first scenario (on the basis of current trends in Russian outward FDI) is regarded as the most beneficial, both for the Russian Federation and for the whole Western community. The second scenario deals with a probable situation in which Russian companies will focus their FDI activity on the former Soviet Republics. It concludes that, in such a case, they would be used as tools of the Russian Federation's foreign policy and that would lead to growing political suspicion and an arms race. One can ask: why is it more dangerous for the world if the Russian Federation strengthens its ties with the Ukraine and Kazakhstan than with the EU? Why is it more dangerous in the case of the Russian Federation than in that of other large countries of the world if foreign policy tries influence the behaviour of "national champions"? The authors do not provide answers to these questions.

The general impression after reading both books is that they fill a huge gap in FDI studies. The combination of case studies with general analysis assures sound results and increases our knowledge of the outward FDI of CEE.

**Alexander Bulatov**  
Professor, MGIMO University –  
Moscow State Institute of International Relations  
of the Ministry of International Affairs of Russia  
Moscow, Russian Federation

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*Industrial Restructuring in East Asia: Towards the 21st Century*

Seiichi Masuyama, Donna Vandenbrink  
and Chia Siow Yue, editors

(Singapore, Institute of Southeast Asian Studies and Tokyo,  
Nomura Research Institute, 2001), 352 pages

This is an interesting edited book, which seeks to examine economic restructuring, in general, and industrial transformation, in particular. It brings together papers from a workshop presented by some of the most established East Asian economists. The main strength of the volume is an unfettered assessment of the reality and prospects these economies face. It is a timely volume offering an opportunity for examining structural change in the East Asian economies, particularly after the bubble burst in the aftermath of the financial crisis of 1997-1998. The individual chapters examine Indonesia, Philippines, Thailand, Malaysia, Singapore, Hong Kong (China), Taiwan Province of China, the Republic of Korea, China and Japan. The introduction is particularly insightful as it provides an excellent historical backdrop for the subsequent discussion. With the exception of the Indonesian chapter (which is a complete outlier), the remaining chapters address the issues attempted.

However, the book seems to lose steam towards the end – perhaps as a result of diminishing returns arising from a too long introduction. The attempt to discuss prospects for the individual economies both robs some of the shine and contradicts with the position of some of the individual chapters. For example, the introduction calls for further deregulation and liberalization while the chapter on Hong Kong (China) calls for a more dynamic industrial policy (although it slants towards functional, rather than selective, intervention).

It may also have been helpful for the reader if the authors had addressed some minor points. It would have been useful for the editors to qualify their use of industrial classifications (figure 1.1 on p. 10) as industrial restructuring that directed at sustaining

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improvements in disposable income need not necessarily mean less emphasis on the technology used by the resource-based, medium- and low-technology industries in the classification used. For example, garment manufacturing has become so intensive in information and communication technology that the proliferation of software in the industry has been critical for firms to sustain competitiveness. A much more rigorous assessment is necessary to dismiss the successful advance of Japan, the Republic of Korea and Taiwan Province of China as driven strongly by factor inputs rather than technical change (pp. 12-13). While the emphasis on large-scale operations stifled growth of small and medium-sized enterprises, it is unclear if protection added to that problem (p. 17). Also, the editors' arguments that the dispersed industrial structure of Taiwan Province of China may not have stimulated investment in innovative activities (p. 18), or the role played by the authorities to resolve the problem of missing and failing markets, would suggest that liberalization itself should be undertaken carefully and selectively – which the editors allude to on pp. 46-49, though the final section takes a liberal stance (p. 49).

The editors may consider the commodity chain (producer-buyer) argument of Gary Gereffi (2001) when making the claim about information industries being horizontally dispersed (p. 24). The diffusion of information technology (IT) into other industries has already triggered similar developments in other industries – e.g. garment and auto parts manufacturing. Taiwan Province of China is a major auto parts patent taker in the United States and yet there are no local automobile assemblers there. There should also be an attempt to distinguish IT manufacturing in Taiwan Province of China and the Republic of Korea from the South-East Asian economies owing to the strong participation of firms in designing and research and development (R&D) operations in the former (p. 26). Also, the generalization made here about marginalization in value added terms in the IT industry seems to contradict the position taken on p. 24.

The assumption that the Anglo-Saxon model is liberal (p. 27) needs to be re-examined in the context of the history of industrialization (Chang, 2002). Despite a much more liberal

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environment, the Organisation for Economic Co-operation and Development reported that the amount of R&D activities by transnational corporations (TNCs) undertaken outside their home base only came to a around 2% of the total in 1997 (p. 32). There should have been an attempt to distinguish innovation rents from unproductive rents (pp. 33 and 41). This point is implied on p. 38, which discourages passive subjugation to TNCs. Also, the notion of “old industries” needs to be recasted in light of the diffusion of advanced technology in traditional industries. More evidence and argument is necessary to assume the emergence of a digital divide in East Asia (p. 42), and the recommendation for the implementation of United States-type financial systems (p. 43). While reforms appear compulsory, do small economies enjoy the relative strength of steering safely in stormy financial waters the way the world’s largest economy could do? Also, the United States attracts human capital selectively (to offset a major decline in student enrolment in science- and technology-related tertiary education from the late 1980s) rather than liberally, to selectively assist its technological development (p. 45).

The advanced flying geese framework seems to ignore the problems the initial model intended to highlight (p. 39). While the trade and investment dynamism associated with the model remains sound, the notion of a leading goose with gaggles of following geese and a misunderstanding of technical change had always caused problems to both Kaname Akamatsu’s (1962) model and the product cycle theory of Raymond Vernon (1966).

Chapters three, four and five discuss Philippines, Thai and Malaysian industrialization, respectively. The Philippines chapter comes out as an incisive and concise one. In turn, the Thai chapter appears somewhat eclectic, vacillating between focus on industrial promotion and deregulation. Interestingly, the chapter considers incentives to be relevant when compared to the Thai chapter, which regards them as largely redundant and a drain on tax revenues. In the light of the intense competition between governments to attract FDI in South-East Asia, it is important to provide a much more rigorous discussion

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on the role of incentives and counter-policies necessary to optimize resource allocation. In addition to an overview of structural change, the Malaysian chapter discusses an important dimension of demand-supply skill trends. If the Government of Malaysia emphasized technology development after 1985, why was this reflected in commensurate productivity improvements? (The total factor productivity levels cited over the period 1986-1993 are extremely low; see pp. 150-161.)

Chapters six and seven examine industrialization and de-industrialization in Singapore and Hong Kong (China), respectively. The former offers an incisive account on the role of government in building a strong science and technology infrastructure in Singapore, and seems to conclude the same policies might also cause an undoing of these endowments. The chapter on Hong Kong (China) takes on board frontier economic arguments on learning, innovation and competition, which should have been addressed in the introductory chapter. The authors make a convincing case for industrial policy – even if the focus is on functional as opposed to selective – to support technology development in Hong Kong (China).

Chapters eight and nine examine Taiwan Province of China and the Republic of Korea. The former one presents the case of Taiwan Province of China within the framework of the Asia-Pacific Regional Operations Center Plan. This approach falls short of a full examination of restructuring in the country. A fuller focused assessment would have provided important lessons for other economies. The Korean chapter analyzes important new strategies that may help firms navigate effectively in the changing competitive circumstances engulfing manufacturers globally.

The final two chapters examine China and Japan. The former addresses some of the salient weaknesses of industrial transformation in China, but perhaps should have also examined the basis for expansion in certain high-technology sectors. Cheap and unskilled labour alone cannot explain the massive expansion of the semiconductor and information hardware industries. The

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Japanese chapter rightly discusses restructuring given the stagnation the economy has faced since 1989. While interesting examples of the infusion of orderly administration following reforms are provided, it would also have been useful to see how innovation can be stimulated under a changing environment.

Overall, despite some contradictions and inconsistencies, this book comes out as a useful compilation of analysis on economic change in East Asia. Policy makers and academics should benefit from reading it.

**Rajah Rasiah**  
Senior Research Fellow  
Institute for New Technologies  
United Nations University  
Maastricht, The Netherlands

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## JUST PUBLISHED

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### ***World Investment Report 2003: FDI Policies for Development: National and International Perspectives***

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***The Development Dimension of FDI: Policy and Rule-Making Perspectives***

(Proceedings of the Expert Meeting held in Geneva,  
from 6 to 8 November 2002)

(Sales No. E.03.II.D.22)(\$35)

The past quarter century has witnessed a remarkable growth in global FDI flows and the liberalization of national FDI policies. While FDI offers recipient economies important potential benefits, such benefits cannot be taken for granted. Simply opening up to FDI does not guarantee inflows, and even when countries do manage to attract FDI, the implications for development differ considerably, depending on the circumstances. Government policies are vital for enhancing the developmental impact of FDI. Furthermore, at the same time as barriers to cross-border exchanges are being reduced, including in the area of investment, international cooperation has been strengthened through various international agreements to regulate these exchanges. Countries thus need to ensure that policies undertaken at the national level in pursuit of specific development objectives are enhanced, and not hindered, by international rule making. This volume contains the written submissions presented by scholars and experts at UNCTAD's Expert Meeting on the development dimension of FDI, held in Geneva from 6 to 8 November 2002, namely: Kwasi Abeasi, V. Balasubramanyam, Gunnela Becker, Sanoussi Bilal, Daniel Graymore, John M. Kline, Ari Kokko, Nagesh Kumar, Howard Mann, Percy S. Mistry, Sol Picciotto, A. Edward Safarian, Magdolna Sass, Pierre Sauvé, M. Sornarajah, Joel P. Trachtman and Dirk W. te Velde.

***Investment Policy Review of Nepal***

(UNCTAD/ITE/IPC/MISC/2003/1)

<http://www.unctad.org/ipr/nepal.pdf>

Nepal offers various advantages to investors, including a privileged access to a well-disposed neighbouring country with a large market; a low-wage, trainable workforce; a flourishing

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local entrepreneurial culture; and an established international recognition thanks to tourist landmarks. However, despite these advantages, and policy reforms initiated in the early 1990s, Nepal has not attracted much FDI so far. This is so partly because of the logistical difficulties arising from locating economic activities in a small, least developed, landlocked and mountainous country, as well as serious weaknesses in the investment framework highlighted in this Report. Chapter I examines the patterns of FDI in Nepal. Most of the projects are concentrated in niche industries, such as tourism, light manufacturing (apparel) and mineral deposits (lime stone), resulting in modest improvements in skills to local employees. Chapter II reviews the investment framework. The report notes that there is scope for tax, regulatory and administrative reforms. The challenge for Nepal is to shift from red tape to red carpet. Chapter III considers FDI strategy. Besides attracting FDI in its niche industries in the short run, Nepal has to be proactive to take further advantage from its trade treaty with India and its LDC trade preferences with developed countries. In the longer term, FDI can play a role in telecommunication and electricity if appropriate regimes are put in place. There is also need to improve the human resource base in order to attract higher technology FDI. Chapter IV highlights the main conclusions and recommendations of the *Investment Policy Review of Nepal*.

***Investment and Technology Policies for Competitiveness:  
Review of Successful Country Experiences***

(UNCTAD/ITE/ICP/2003/2)

<http://www.unctad.org/stdev/invest.doc>

This study addresses the role of FDI in technology transfer and learning, particularly by TNCs. It highlights the important role that TNCs can play in the transfer of technology, but emphasizes that the latter should be maximized and complemented by appropriate country policies. It identifies key trends in the global economy to demonstrate that technology-intensive products have the fastest-increasing share of growing world trade, and that developing countries should therefore develop capabilities in technology-intensive products. It further identifies the notable

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success achieved by South East-Asia. The study also discusses the role of FDI, research and development, licensing, information and communication technology infrastructure and human capital as key structural determinants of industrial competitiveness, which technology policy should focus on. It considers FDI-targeting strategies, and argues that there is a prominent role for policy interventions. On the basis of its evaluation of the country case studies in the Annex, the study considers the strategies used successfully to build domestic capabilities, providing a broad set of policy options from which to choose. However, there is no single path to competitive success. The study emphasizes the variety of paths followed by different countries. It summarizes conclusions from its review of the key issues surrounding strategic competitiveness and country strategies.

***Bezpośrednie inwestycje zagraniczne na świecie i w Polsce:  
tendencje, determinanty i wpływ na gospodarkę  
[Foreign Direct Investment in the World and Poland:  
Trends, Determinants and Economic Impact]***

(ISBN 83-918182-0-9)

(Joint publication with the Ministry of Economy, Poland,  
Warsaw)

FDI has become part of the economy of almost every country in the world, Poland included. Countries attract FDI because it is a package of resources including not only capital but also technology, managerial skills and marketing skills. Understanding the determinants of FDI and its impact – both positive and negative – on the economies of host countries is indispensable if it is to be used to advance economic development. This book consists of three chapters, each of which has two parts. The first ones of each chapter are prepared on the basis of UNCTAD's *World Investment Reports*, and deal with global issues. The second parts analyse the Polish experience. Chapter I examines FDI trends worldwide and in Poland. Chapter II deals with FDI determinants. Chapter II deals with the impact of FDI on host countries, particularly as regards competitiveness. Copies of this publication can be obtained from the Ministry of Economy, Poland, Warsaw.

**Press materials on FDI issued from May to August 2003**  
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Title	Date	Document symbol	http:
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## **Books on FDI and TNCs received since April 2003**

Crystal, Jonathan, *Unwanted Company: Foreign Investment in American Industries* (Ithaca and London: Cornell University Press, 2003), 203 pages.

Jaklic, Andreja and Marjan Svetlicic, *Enhanced Transition Through Outward Internationalization: Outward FDI by Slovenian Firms* (Aldershot, Hampshire: Ashgate, 2003), 344 pages.

Kumar, Nagesh, *Globalization and the Quality of Foreign Direct Investment* (New Delhi: Oxford University Press, 2002), 257 pages.

Lall, Sanjaya and Shujiro Urata, editors, *Competitiveness, FDI and Technological Activity in East Asia* (Cheltenham and Northampton, MA: Edward Elgar, 2003), 411 pages.

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Dunning, John H. (1979). “Explaining changing patterns of international production: in defence of the eclectic theory”, *Oxford Bulletin of Economics and Statistics*, 41 (November), pp. 269-295.

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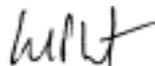
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