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Foreign Direct Investment and its Role in Economic Development: Do We Need a New Agenda?

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Abstract

Despite globalisation, the essential role of foreign direct investment (FDI) in economic development has not changed. However, many mechanisms and dynamics of FDI-assisted development have changed: there is greater variation in the kinds of FDI, the benefits each offers, and the manner in which each interacts with the host economy. This introductory article attempts to place the discussions and issues raised in this special issue of The European Journal of Development Research within the wider literature on FDI and development. The articles here analyse the role of multinational enterprises (MNEs) in industrial development in a 'learning system' perspective. They also analyse the policy tools available for using FDI for economic development in a liberalising, post-World Trade Organisation world, and the constraints to doing this. While this is a nascent debate, this special issue points to a variety of 'soft' policy options that provide a pragmatic response to the complexities of globalisation.

I . INTRODUCTION

The past two or three decades have seen a significant policy shift in the developing world, from inward-looking import substitution to outward-looking, market determined strategies. The reasons for this shift are complex, but mainly have to do with the inefficiencies of import substitution, the growth of globalised production and the success of the export-oriented Asian newly industrialised economies (NIEs). One key feature of liberalisation has been greater openness to foreign direct investment (FDI) as a means of acquiring technologies, skills and access to international markets, and of entering dynamic trade and production systems internal to multinational enterprises (MNEs).

The role of the MNE as a source of capital and technology has grown over time, as other sources of capital have become scarcer or more volatile and technical change has accelerated. MNEs continue to dominate the creation of technology; indeed, with the rising costs and risks of innovation their importance has risen (with the exception of very new technology areas). They have also become more mobile, searching the world for lower cost, more efficient production sites and for new markets. The interaction of technical change (with its need for more and higher skills and better infrastructure) with greater FDI mobility has not reduced the need for local capabilities in developing countries. On the contrary, entry levels for attracting (non-resource-extracting) FDI have risen, and investors (especially in activities facing world competition) are focusing on countries with strong local capabilities. Mobile MNEs, in other words, seek strong complementary factors wherever they locate. There is no conflict over the long term between inward FDI and domestic capabilities.

However, liberalisation has not always increased FDI inflows into host developing countries. The reason is simple. The removal of restrictions on FDI does not create the complementary factors that MNEs need; it only allows them to exploit existing capabilities more freely. Thus, FDI response tends to be most vigorous where local capabilities are strong when liberalisation takes place, and feeblest where they are weak (of course, excluding resource extraction). Similarly, over time, FDI inflows rise where local capabilities are strengthened and new capabilities are created; they stagnate or fall where they are not. This still has not, surprisingly, been internalised in policy recommendations on FDI in developing countries – much of this still proposes liberalisation not just as a necessary but also as a sufficient condition for attracting FDI and extracting most development benefits from it.

There is thus a need to look afresh at the role of MNEs and FDI policies in developing countries. This is the objective of this special issue, and one which the current article seeks to highlight by placing these contributions within the context of the literature on FDI and development. The articles here indicate that much of what we already know about FDI in economic development remains valid. It is clear, for instance, that the creation of linkages and the internalisation of spillovers from MNE activities still depend on local absorptive capacity. However, we know more now on how these mechanisms work. Complementary assets in the host country reflect its stage of development, in turn influenced by its history, geography and business systems. Some articles in this issue increase our understanding of the nature of absorptive capacities in a ‘systems of learning’ perspective.

This special issue also analyses the FDI policy tools, constraints and options for host countries in the face of the changing global economy. How do countries respond to the limitations on traditional policy tools placed by World Trade Organisation (WTO) protocols such as the Subsidies and Countervailing Measures Agreement (SCM), Trade-related Aspects of Intellectual Property Rights (TRIPS) and so on? Several articles point to the ‘soft’ policy options that may provide an appropriate

response to the complexities of globalisation.

DEVELOPMENT CONSTRAINTS AND OPPORTUNITIES OFFERED BY FDI

The Washington consensus holds, in broad terms, that markets for knowledge are efficient, and that FDI flows will – ceteris paribus – generate positive externalities for domestic firms. This presumes that all MNE activity offers similar spillovers and development benefits. Its focus is thus mainly on the quantity of FDI rather than its quality. There are four points here that we must qualify. The quality of FDI spillovers depends on the scope and competence of the subsidiary. These depend partly on factors internal to MNEs, including their internationalisation strategy, the role of particular affiliates in their global system and the motivation for their investment. Internal strategies interact with host country capabilities and resources [Benito et al., 2003]. Affiliates undertaking complex activities need high levels of local competence: advanced specialised skills, strong industrial and service firms and clusters, and strong support institutions. Where host countries cannot provide high level local assets, MNEs will not set up high quality affiliates. For instance, research and development activities concentrate in the few locations that can provide the advanced resources and institutions.

ABSORPTIVE CAPACITY

How does the nature of location advantages determine the ability of the domestic economy to absorb spillovers from FDI? As almost all the articles in this special issue illustrate, the presence of externalities does not mean either that the domestic economy can internalise them, or that the externalities are significant in quantity or quality. Absorptive capacity is significant for development because it allows domestic actors to capture knowledge that exists elsewhere. Where absorptive capacity is lacking in domestic firms, they may, instead of reaping technological benefits from FDI, be ‘crowded out’ [Agosin and Mayer, 2000].

Capabilities in the host country context matter for the magnitude and intensity of technological upgrading. As Portelli and Narula [2004] have shown in the case of Tanzania, FDI in activities that match the comparative advantage of the host country provides greater linkages. Wider technology gaps between domestic and foreign-owned activities tend to lead to fewer backward linkages and to lower technological content in the inputs sourced locally.

Several authors, such as Findlay [1978] and Perez and Soete [1988], have noted that a minimum level of scientific and technical knowledge is required to use innovation. Below this level, the cost of adoption can be prohibitive. This is particularly true for FDI. Borensztein et al. [1998] show that, at country level, a minimum threshold of absorptive capacity is necessary for FDI to contribute to higher productivity growth. At the firm level, Narula and Marin [2003] show that only firms with high absorptive capacity are likely to benefit from FDI spillovers. Xu [2000] also shows that a country needs to reach a minimum human capital threshold

level in order to benefit from technology transfer.

While insufficient absorptive capacity tends to lead to the inefficient use of technology inflows, knowledge accumulation is much more rapid once the threshold level of absorptive capacity is crossed. Simply put, technology absorption is easier once countries have 'learned-to-learn' [Criscuolo and Narula, 2002]. The cost of imitation increases as the follower closes the gap with the leader and the number of technologies available for imitation falls. This implies that there are diminishing returns on marginal increases in absorptive capacity as firms approach the frontier of knowledge [Narula, 2004].

Kokko et al. [2001] highlight the role of past industrialisation experience as a precondition for technology transfer. The absence of such experience is concomitant to lack of local absorptive capacity [Radosevic, 1999]. For example, in sub-Saharan Africa, the conditions that stimulate technological assimilation (such as developed human capital, adequate physical infrastructure and a dynamic business climate) are absent. This constrains the ability of African countries to master foreign technology and to compete in international markets [Mytelka, 1985; Lall and Pietrobelli, 2002]. The development of capacities and capabilities is key both to attracting FDI as well as to increasing MNE technological spillovers.

TAKING A SYSTEMS VIEW TO ABSORPTION AND INDUSTRIAL

DEVELOPMENT

industrial development and absorptive capacity must be seen from a 'systems' view. By this we mean that while learning and absorption take place at the firm level, the success or failure of individual firms occurs within a 'system'.[1] Within a system, there exists a broad knowledge base outside industrial enterprises; this base is central to technological accumulation by industry. Learning and innovation involve complex interactions between firms and their environment. The environment consists of the firms' networks of direct customers and suppliers but it stretches much further. It also includes the broader factors shaping their behaviour and activities: the social and cultural context; the institutional and organisational framework; infrastructure; knowledge creating and diffusing institutions, and so on. This is the essence of the systems approach to technology.

INDUSTRIAL POLICY AND FDI - ASSISTED DEVELOPMENT

The articles in this special issue all point to a basic paradox: with weak local capabilities, industrialisation has to be more dependent on FDI. However, FDI cannot drive industrial growth without local capabilities. The neo-liberal approach favoured by the Washington consensus which leaves capability development to free market forces provides few realistic answers. It can result in slow and truncated technological development, with gaps between countries rising. Some upgrading does take place,

but is slower and more limited than with the promotion of local capabilities. Given the speed at which technologies are changing and path-dependence and cumulativeness in capability building, it can lead to latecomers being mired in low growth traps.

The policy needs of capability building have not changed much. They are direct – the infant industry case to provide 'space' for enterprises to master new technologies without incurring enormous and unpredictable losses – and indirect, to ensure that skill, capital, technology and infrastructure markets meet their needs. There is also a need to co-ordinate learning across enterprises and activities, when these are linked in the production chain and imports cannot substitute effectively for local inputs. At the same time, technical change makes it necessary to provide more access to international technology markets; it also makes it more difficult to anticipate which activities are likely to succeed. The information needs of industrial policy rise in tandem with technological change and complexity. The greater complexity of technology does not make selectivity unfeasible. Detailed targeting of technologies, products or enterprises may be more difficult because of the pace of change, but targeting at higher levels is feasible and more necessary. Technological progress may actually make industrial policy easier in some respects: information on technological trends and markets is more readily available, more is known about the policies in successful countries and benchmarking is easier.

CONCLUDING REMARKS

Our objective in writing this introductory article has been to place the various contributions to this special issue in the context of the broad range of inter-disciplinary research on FDI and development.

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These have been referred to as innovation systems [see e.g., Lundvall, 1992; Edquist, 1997] or learning systems [Lall, 1992; Viotti, 2002].

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