Virtual Institute
Study tour on trade and development for Colombian member universities

Foreign Direct Investment and Enterprise Development

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Kalman Kalotay
UNCTAD/DIAE
Outline

I. Why do we put enterprise development together with FDI?
II. Basic considerations about foreign direct investment: motivations, determinants
III. Global FDI trends
IV. Development issues
V. Policy issues
VI. The link between foreign and local firms: supplier linkages
I. Why do we put enterprise development together with FDI?
Why entrepreneurship matters

- Basis for economic growth
- Basis for job creation (more than FDI)
- Basis for poverty reduction
- Source of product and process innovations
- ... but needs synergies with foreign firms (see FDI)

Praise from the World Bank:
“Entrepreneurial activity is a pillar of economic growth. For evidence of the economic power of entrepreneurship, we need look no further than the United States, where young firms have been shown to be a more important source of net job creation than incumbent firms.”

Praise from the OECD:
“Entrepreneurship and entrepreneurs have long been recognised as important sources of innovation, and thereby also of growth and employment.”
Key components of an entrepreneurship policy framework

1. Formulating National Entrepreneurship Strategy
2. Optimizing the Regulatory Environment
3. Enhancing Entrepreneurship Education and Skills Development
4. Facilitating Technology Exchange and Innovation
5. Improving Access to Finance
6. Promoting Awareness and Networking

Source: UNCTAD.
II. Basic considerations about foreign direct investment
Motivations of investors

Profits, derived from:

- **natural resources**
  - Oil and gas extraction, mining, etc

- **Markets** (horizontal FDI)
  - Access a domestic or regional (EU, NAFTA, ASEAN) market

- **Cost efficiency** (vertical FDI)
  - Specialize and divide production in line with the comparative advantages of different locations; export-oriented FDI

- **Strategic assets** (primarily through M&As)
## Economic determinants of FDI

<table>
<thead>
<tr>
<th>Type of FDI</th>
<th>Key determinants</th>
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<tr>
<td>Natural resource-seeking FDI</td>
<td>Abundance of natural resources</td>
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<td>Price movements</td>
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<td>Access to skills</td>
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<td>Market-seeking FDI (national or regional)</td>
<td>Market size and purchasing power</td>
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<td>Market growth</td>
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<td>Tradability of product/service</td>
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<td>Need for local adaptation</td>
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<td>Structure and openness of markets</td>
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<td>Efficiency-seeking, export-oriented FDI</td>
<td>Quality and cost of human resources</td>
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<td>Physical infrastructure (ports, roads, telecom, etc.)</td>
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<td>Technical infrastructure</td>
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<td>Trade costs</td>
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<td>Quality of suppliers, clusters, etc.</td>
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<td>Economic and political stability</td>
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<td>Strategic asset-seeking FDI</td>
<td>Presence of firm-specific assets</td>
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<td>Efficiency and transparency of financial markets</td>
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Policy determinants of FDI

- Stability of the country
  - Economic stability
  - Political stability
  - Social stability
- Rule of the law
- Policies on the functioning and the structure of markets
  - Competition and M&A policies
  - Intellectual property policy
  - Anti-corruption policy
- Labour (employment) policy
- Environmental protection policy
- Tax policy
- Trade policy (tariffs and non-tariff barriers)
- Regional integration policies
Facilitation of FDI as a determinant

✓ Rules regarding entry and operations of foreign investors
  ✓ Openness to foreign investors (general and by sectors)
  ✓ Registration rules and requirements for foreign investors
  ✓ Licensing requirements
  ✓ Construction permits
✓ Standards of treatment of foreign affiliates
✓ Rules on transfer of funds
✓ Rules on expropriation
✓ Access to dispute settlement
✓ Investment promotion services
✓ Investment incentives and performance requirements
✓ Rules on the employment of foreigners
✓ Social amenities (bilingual schools, quality of life, etc.)
✓ International investment agreements
III. Global FDI trends
Ups and downs in global FDI flows

(Billions of dollars)
Half of the 20 largest recipients are developing or transition economies
Developing and transition economies account for 39% of global outward FDI

Shares in global FDI outflows, by group of economies, 1999–2013

(Per cent)

- Developed economies
- Developing and transition economies economies

[Graph showing the percentage share of FDI outflows by group of economies from 1999 to 2013]
6 of the 20 largest FDI sources are developing or transition economies

(Billions of dollars)
10-year trends in selected Latin American countries

Billions of dollars

- Brazil
- Mexico
- Chile
- Colombia
- Peru

Source: United Nations Conference on Trade and Development (UNCTAD)
IV. Development issues
Potential benefits of FDI

- Capital and investment
- Technology transfer
- Skills upgrading
- Employment
- Linkages
- Exports
- Access to foreign markets or supplies
- Creation of new economic activities (especially in greenfield FDI)
- Fiscal revenue for the host Government (taxes)
- Higher productivity
- Potentially more environmentally friendly production
- Restructuring of existing firms or industries
- Increased competition
- Increased systemic competitiveness of the host economy

*FDI: to be treated as a package of resources*
The flipside of FDI

- Risk of high profit repatriation
- Enclave-type of activities, footloseness
- Trapping host countries in low value added (no automatic upgrading)
- High import contents
- Risk of regulatory problems in market seeking projects (especially in utilities)
- Crowding out of local firms due to unfair anti-competitive practices
- Low tax revenues due to too generous incentives (race to the bottom)
- Transfer pricing leading to tax evasion
- Environmental leakages (degradation)
- Reduction of labour standards (the problem of sweatshops)
- Potential loss of sovereignty
- Divestment in crisis
V. Policy issues
Liberalization declines, regulation rises

National investment policy changes, 2000–2013
(Per cent of measures)
Spotlight on incentives

Investment incentives as a share of total number of liberalization, promotion and facilitation measures, 2004–2013
(Per cent)
Motivation of investment incentives

Most important objectives of investment incentives for foreign investors
(Per cent of total responses)
VI. The link between foreign and local firms: supplier linkages
Why do TNC-SME linkages matter to host economies?

**GOAL:**
to promote the influx of FDI (*quantity*) and maximize its benefits (*quality*)

- Deeper integration of FDI in the host country through increased participation of local companies in global value chains
- Reduction of imports and improvement in balance of payments
- A stronger, more competitive and sustainable domestic SME sector
- Employment generation (more and better jobs)
- Environmentally and socially sustainable business practices (Corporate social responsibility)
Definition of TNC-SME Linkages

- Mutually beneficial long-term business relations between large foreign companies and domestic SMEs
- One of the main areas for policy intervention to integrate local SMEs into global value chains
The policy role

Improving the investment climate

Specific linkage policies

Strategic FDI attraction

Strengthening absorptive capacity
Business linkage programmes

- Many initiatives promote linkages between TNCs and local SMEs

- No two linkage programmes are the same, even in the same country

- Different forms of financing:
  - Entirely donor-driven programmes
  - Government driven
  - Public-private sector partnerships
  - TNC’s supplier development programmes

- UNCTAD’s approach: complementing policy analysis with technical assistance activities