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Should Countries Promote Foreign Direct Investment?

Gordon H. Hanson

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

SHOULD COUNTRIES PROMOTE FOREIGN DIRECT INVESTMENT?

Gordon H. Hanson

Department of Economics and
School of Business Administration
University of Michigan, Ann Arbor, USA

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Abstract

This paper examines whether policies to promote foreign direct investment (FDI) make economic sense. The discussion focuses on whether existing academic research suggests that the benefits of FDI are sufficient to justify the kind of policy interventions seen in practice.

For small open economies, efficient taxation of foreign and domestic capital depends on their relative mobility. If foreign and domestic capital are equally mobile internationally, it will be optimal for countries to subject both types of capital to equal tax treatment. If foreign capital is more mobile internationally, it will be optimal to have lower taxes on capital owned by foreign residents than on capital owned by domestic residents. Absent market failure, there is no justification for favouring FDI over foreign portfolio investment. In practice, countries appear to tax income from foreign capital at rates lower than those for domestic capital and to subject different forms of foreign investment to very different tax treatment. FDI appears to be sensitive to host-country characteristics. Higher taxes deter foreign investment, while a more educated work force and larger goods markets attract FDI. There is also some evidence that multinationals tend to agglomerate in a manner consistent with location-specific externalities.

There is weak evidence that FDI generates positive spillovers for host economies. While multinationals are attracted to high-productivity countries, and to high-productivity industries within these countries, there is little evidence at the firm or plant level that FDI raises the productivity of domestic enterprises. Indeed, it appears that plants in industries with a larger multinational presence tend to enjoy lower rates of productivity growth over time. Empirical research thus provides little support for the idea that promoting FDI is warranted on welfare grounds.

Subsidies to FDI are more likely to be warranted where multinationals are intensive in the use of elastically supplied factors, where the arrival of multinationals to a market does not lower the market share of domestic firms, and where FDI generates strong positive productivity spillovers for domestic agents. Empirical research suggests that the first and third conditions are unlikely to hold. In the three cases we examine, it appears that the second condition holds, but not the first or third conditions. This suggests that Brazil's subsidies to foreign automobile manufacturers may have lowered national welfare. Costa Rica appears to have been prudent in not offering subsidies in the case of Intel.

There clearly is a need for much more research on the host-economy consequences of FDI. The impression from existing academic literature is that countries should be sceptical about claims that promoting FDI will raise national welfare. A sensible approach for policy makes in host countries is to presume that subsidizing FDI is unwarranted, unless clear evidence is presented to support the argument that the social returns to FDI exceed the private returns.

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I. Introduction

There is a presumption among many academics and policy makers that foreign direct investment (FDI) is somehow special.[1] One common view is that FDI helps accelerate the process of economic development in host countries. Optimism about the economic consequences of foreign investment, coupled with heightened awareness about the importance of new technologies for economic growth, has contributed to wide-reaching changes in national policies on FDI. During the last two decades, many emerging economies have dramatically reduced barriers to FDI, and countries at all levels of development have created a policy infrastructure to attract multinational firms.[2] Standard tactics to promote FDI include the extension of tax holidays, exemptions from import duties, and the offer of direct subsidies. Since 1998, 103 countries have offered special tax concessions to foreign corporations that have set up production ing barriers to foreign investment is a means of achieving global market integration, promoting FDI goes one step further by favouring one form of integration – expanded foreign control of productive assets – over others, such as increased trade in goods, more international licensing of technology, or larger cross-border flows of portfolio capital. Assessing the consequences of promoting FDI for national welfare is a big task and one we in no way pretend to complete in full. We focus on whether existing academic research suggests that the benefits of FDI are sufficient to justify the kind of policy interventions seen in practice. This will help to identify a set of practical guidelines for when and where promoting FDI might be welfare-enhancing.

In the remainder of the introduction, we frame the discussion by outlining the conditions under which economic theory suggests that government policies favouring foreign over domestic capital are