CEPR- RIETI Workshop
"New Challenges to Global Trade and Finance"

Handout

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FDI Promotion: Why and How?

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Is FDI really good for growth?

- “One dollar of FDI is worth no more (and no less) than a dollar of any kind of investment” (D. Rodrik)

- Yet, 59 out of 108 countries surveyed in the World Bank’s census of investment promotion agencies offered FDI incentives in 2004

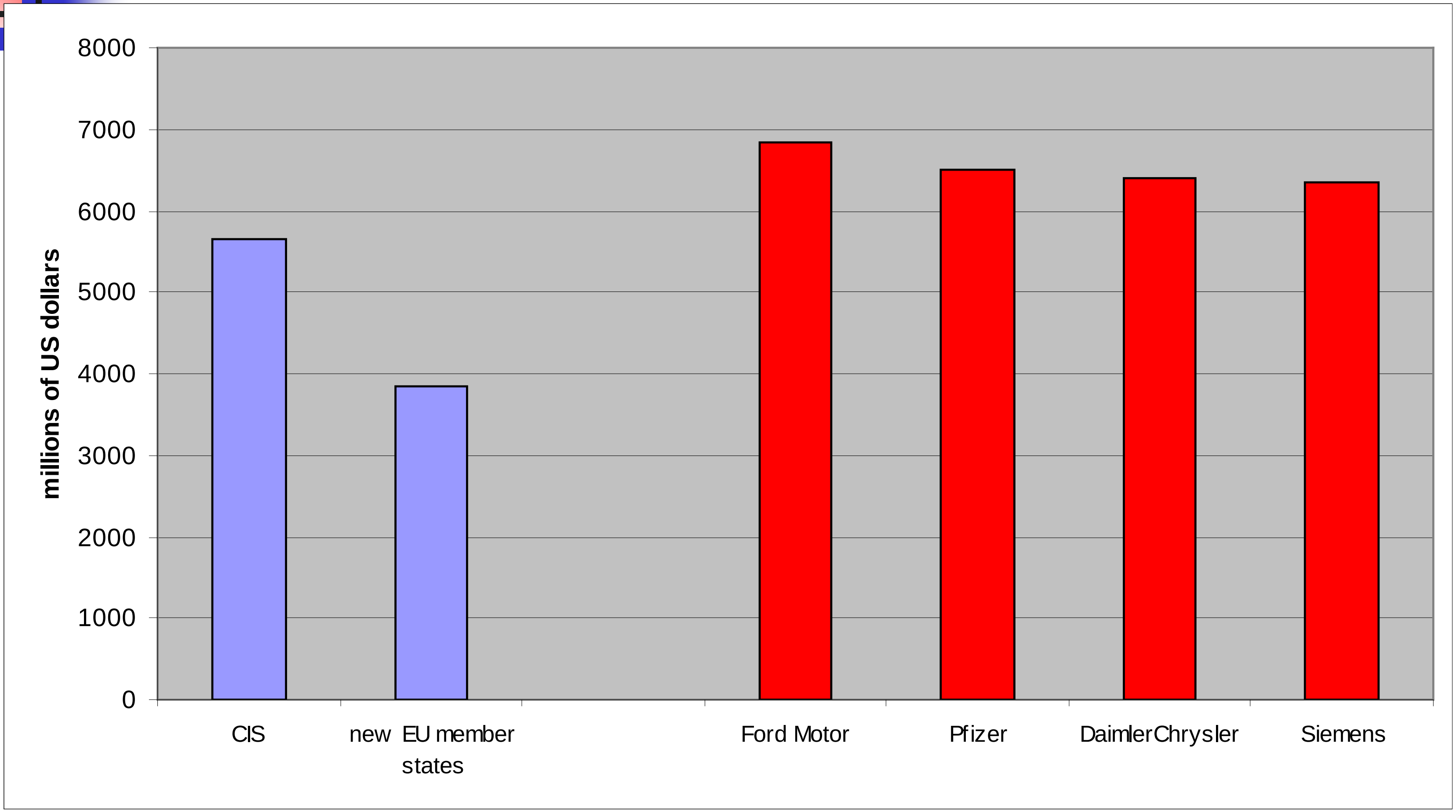
Outline

1. Why should we expect FDI to stimulate growth in host countries?
2. Evidence on knowledge transfer to FDI recipients
3. Effect of FDI on other firms within the industry
4. Effect of FDI on firms in the supplying industries
5. FDI in services and manufacturing performance
6. Is FDI promotion effective?

Technology transfer through FDI => economic growth

- MNCs are responsible for most of the world's R&D
  - 700 multinational corporations accounted for 46% of the world's total R&D expenditure and 69% of the world's business R&D in 2002 (UNCTAD 2005)
  - R&D budgets of large multinationals may exceed R&D spending of some countries

R&D budgets of some MNCs exceed R&D spending of transition countries (2003)



CIS figure includes: Russia, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Ukraine, Uzbekistan.
New EU member states figure includes: Czech Rep, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Rep, Slovenia.

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Effect of FDI on recipient firms

- Key question: Is the superior performance of foreign affiliates due to some intrinsic advantage of foreign ownership or are foreign investors simply good at picking acquisition targets?

Arnold and Javorcik (JIE 2009)

- Examine this question using plant-level information on 400 new FDI recipients in Indonesia (1983-2001)
- Compare the differences in the paths of development between FDI recipients and the control group
- Control group: plants with similar observable characteristics <u>before</u> a foreign acquisition, operating in the same industry/year

$$1/n \ \Sigma_{1 \text{ to } n}[(\text{Productivity}_{\text{FDI recipient, post-FDI}} - \text{Productivity}_{\text{FDI recipient, pre-FDI}}) - (\text{Productivity}_{\text{control, post-FDI}} - \text{Productivity}_{\text{control, pre-FDI}})]$$

Foreign ownership improves performance

Total factor productivity (in logs)				
	Pre-acquisition Year	Acquisition year	One year later	Two years later
FDI recipients	0.864	1.079	1.142	1.215
Control group	0.867	0.976	1.022	1.083
Difference		**0.106*** (0.034)**	**0.122*** (0.045)**	**0.135*** (0.051)**

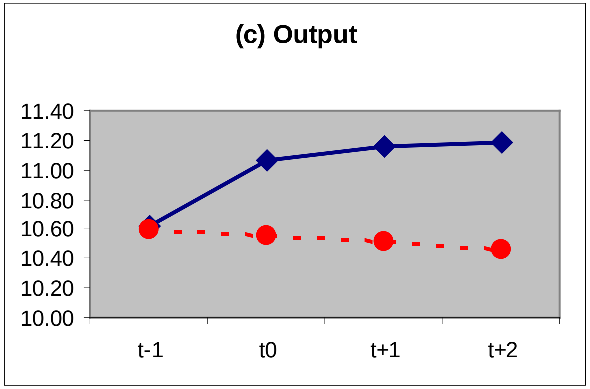
Foreign ownership improves performance

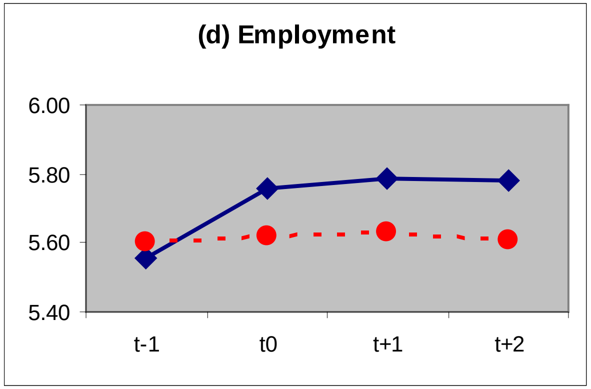
- While best performers tend to receive FDI, foreign ownership also leads to increased productivity
- FDI recipients exhibit a 13.5% higher productivity growth by the end of the 3rd year under foreign ownership

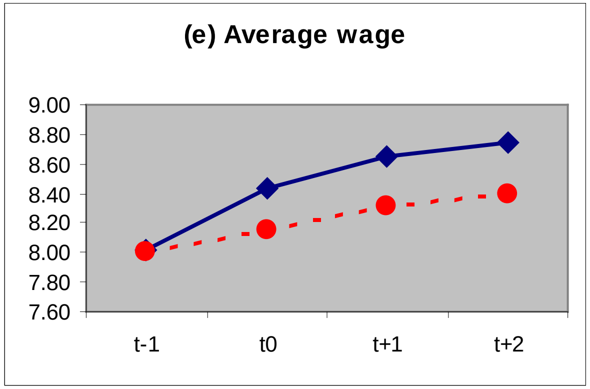
Foreign ownership improves performance

	Labor productivity (in logs)			
	Pre-acquisition Year	Acquisition year	One year later	Two years later
FDI recipients	4.28	4.50	4.60	4.62
Control group	4.20	4.14	4.06	4.05
Difference		**0.280*** (0.072)**	**0.459*** (0.074)**	**0.489*** (0.088)**

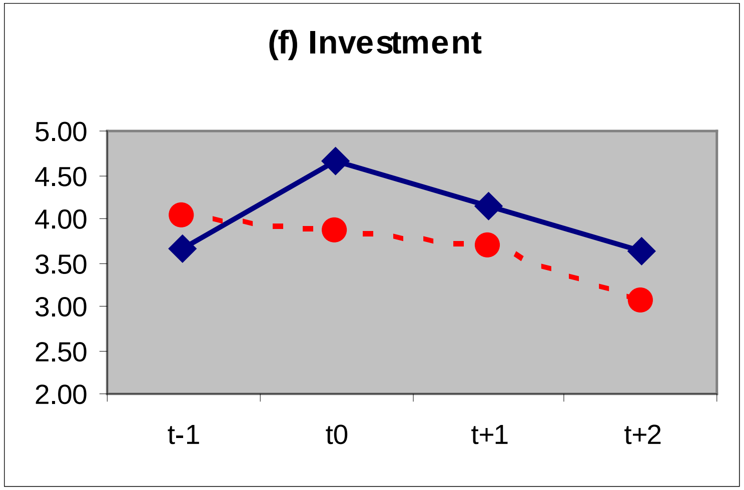
FDI induces rapid changes

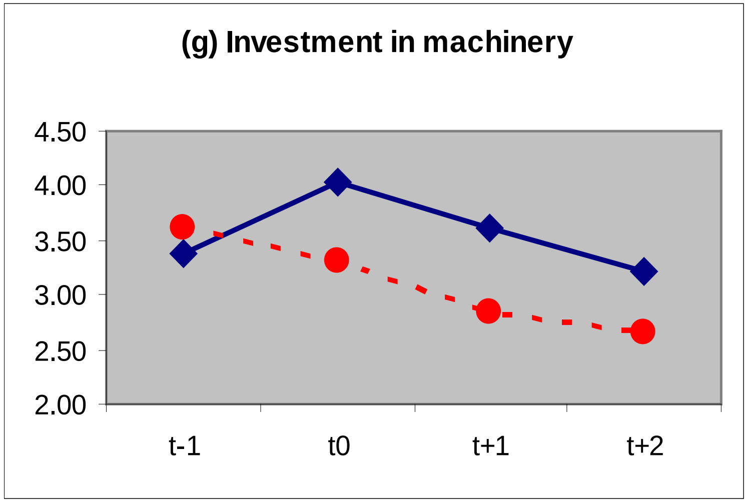




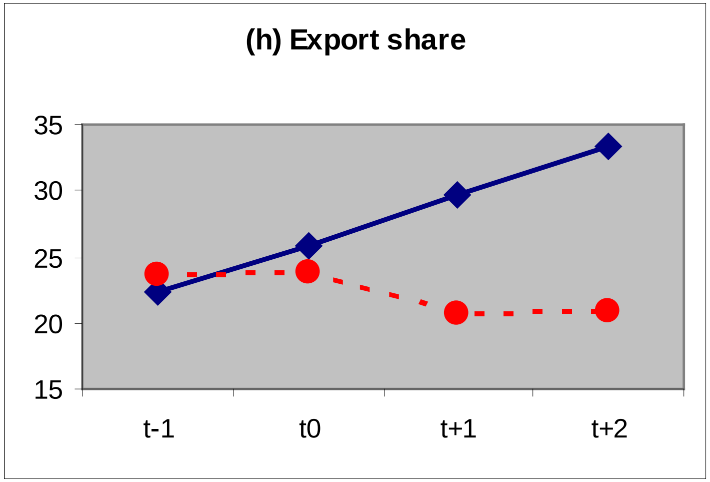


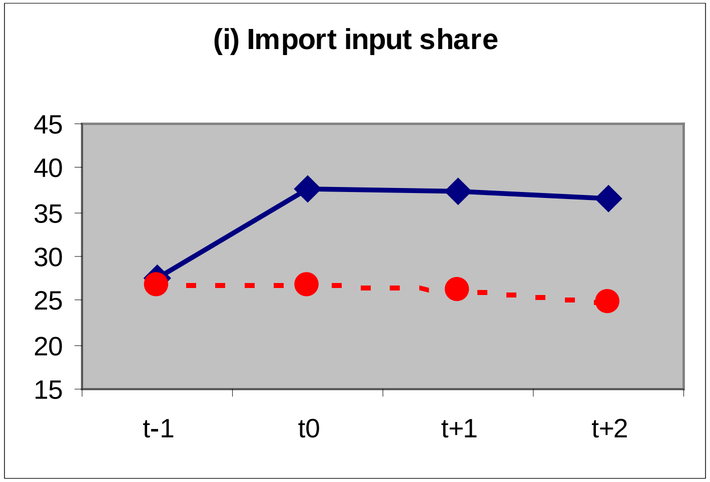
FDI leads to higher investment





FDI facilitates integration into global markets





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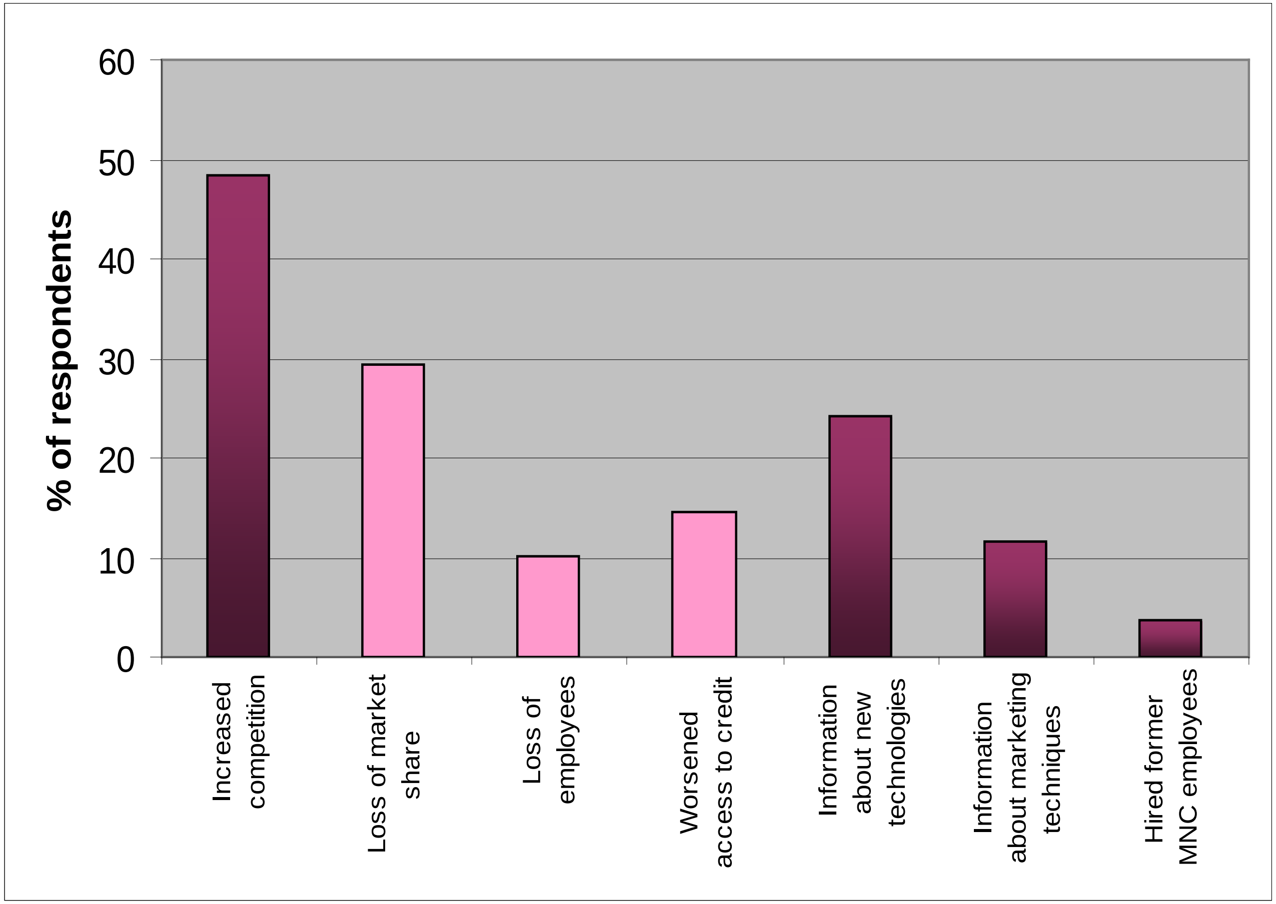
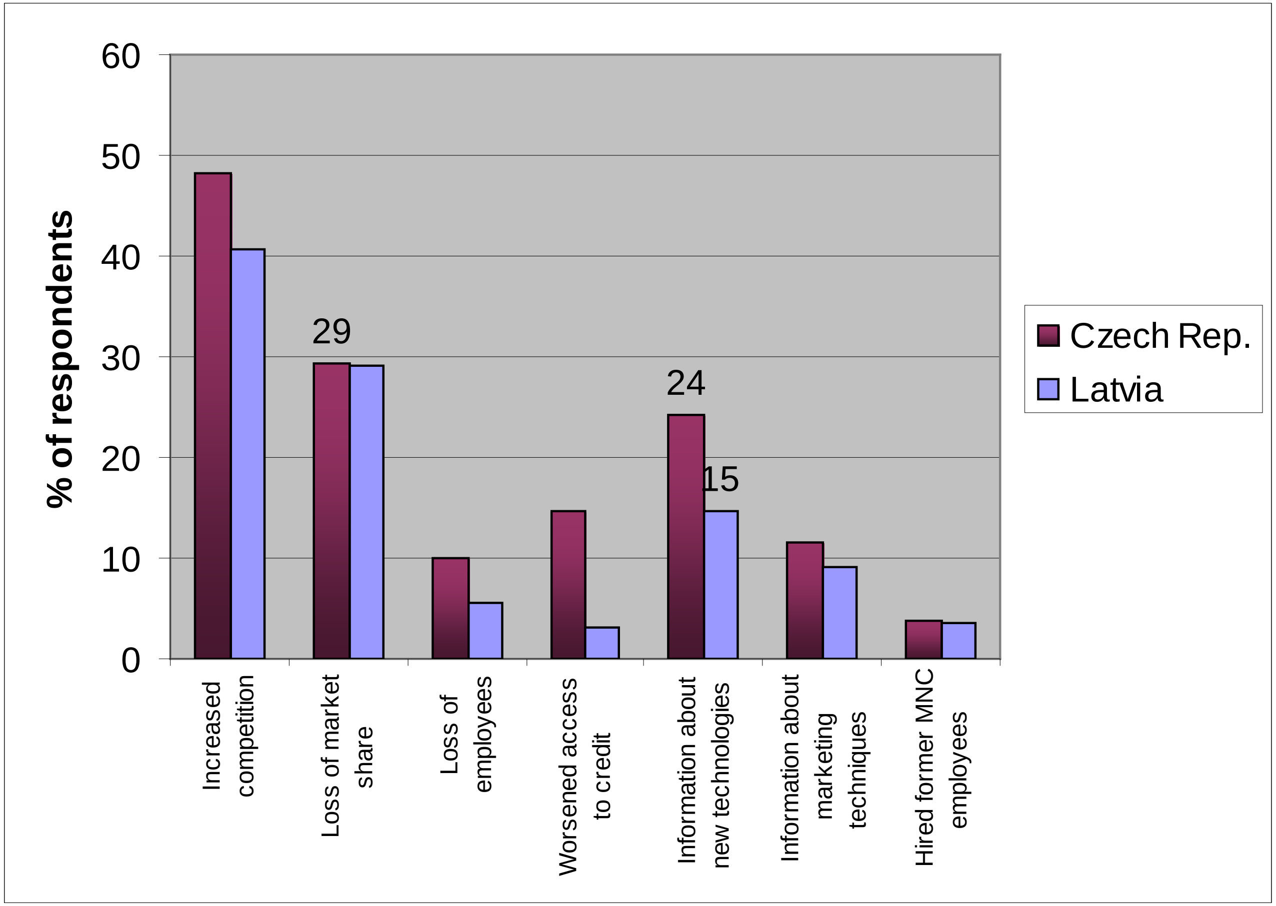
FDI affects domestic firms through multiple channels (Czech Rep.)



Relative magnitudes of the effects differ by country



Intra-industry spillovers more likely in industrialized countries

- Haskel, Pereira and Slaughter (REStat 2007) - UK plant-level data 1973-1992
  - Increase in FDI presence **positively** affects TFP of local plants in the same sector
  - Lesser performers benefit more

- Keller and Yeaple (REStat 2009) – US firm-level data 1987-1996
  - Evidence of **positive** spillovers, particularly in high-tech sectors
  - Absent in low-tech sectors
  - Lesser performers benefit more
  - Accounted for 14% of productivity growth in U.S. firms

- Javorcik (AER 2004) - Lithuanian firm-level data 1996-2000
  - **No evidence** of intra-industry effects

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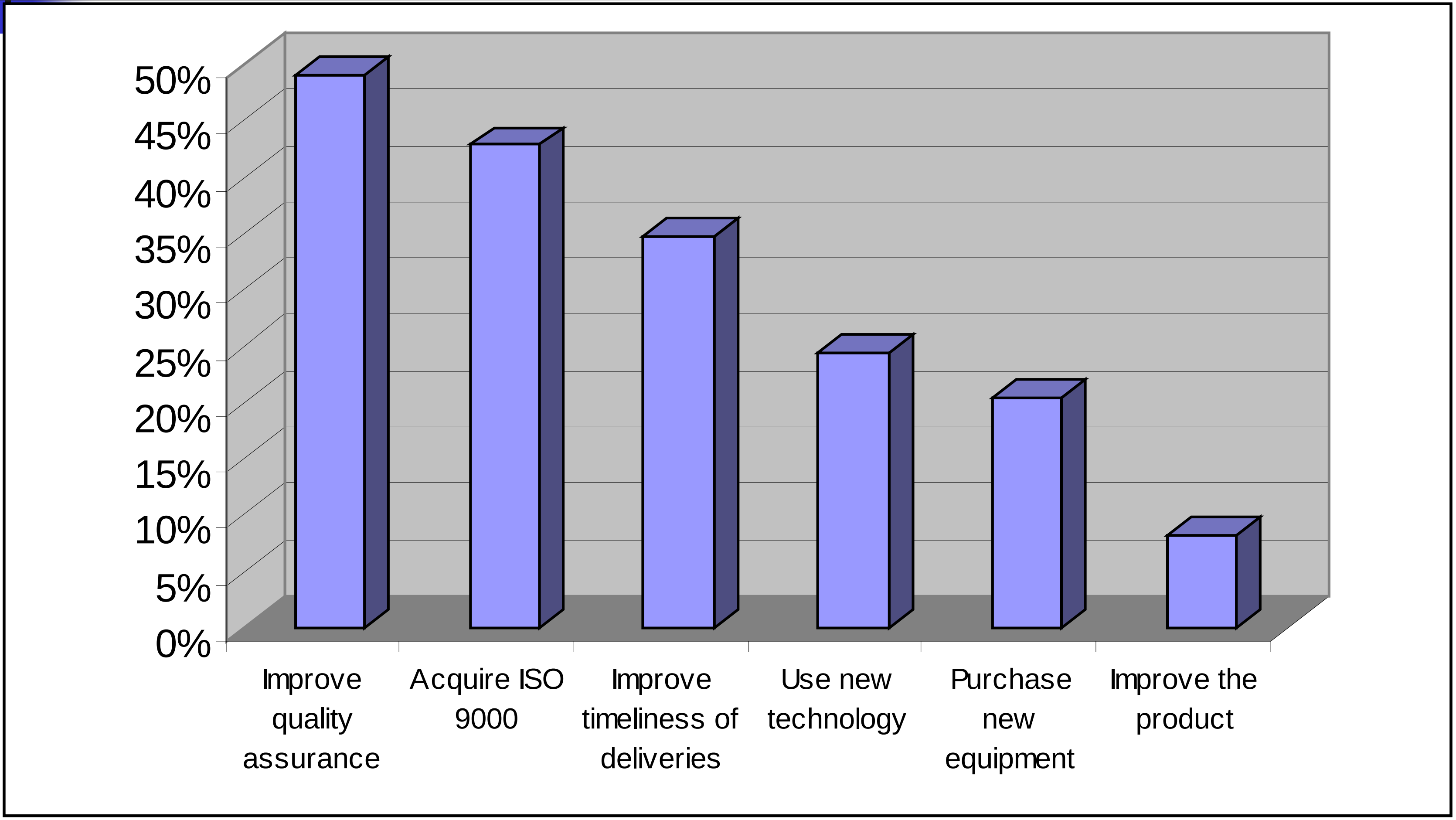
Effect of FDI on firms in the supplying industries

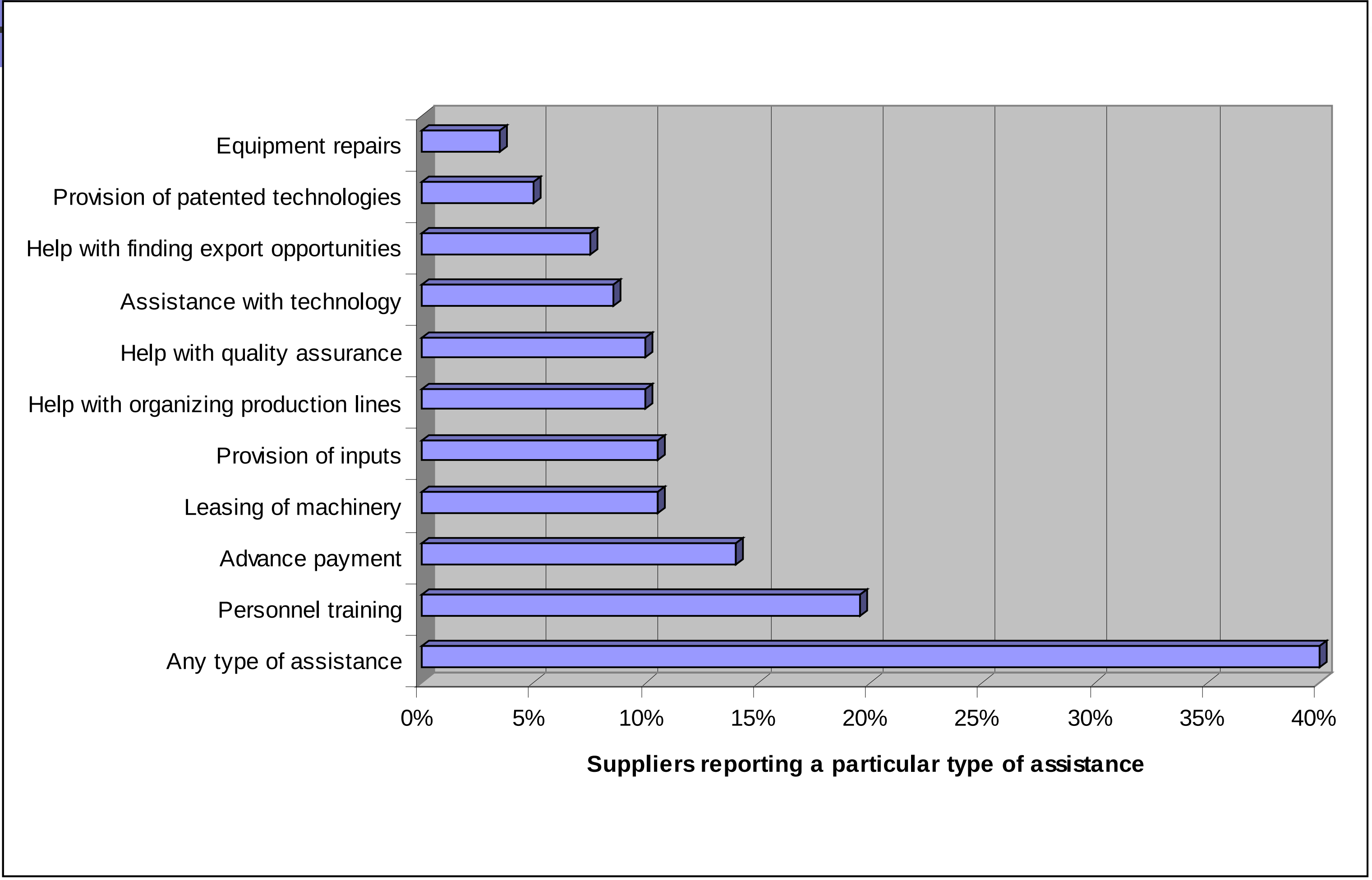
- While MNCs have an incentive to *prevent* leakage of knowledge to their competitors, they may want to *promote* knowledge transfer to local suppliers

- FDI boosts productivity in the supplying industries
  - Evidence from Lithuania (Javorcik AER 2004)
  - Evidence from Indonesia (Gertler and Blalock JIE 2007)

MNCs' requirements vis a vis potential suppliers



Assistance received by Czech firms from MNCs



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What makes services different

- Producer services are an input into many manufacturing industries
- **Cross-border tradability of services is limited**, so manufacturing firms are often at the mercy of local services providers

Evidence from the Czech Rep.

- There is a positive relationship between services sector reform and the performance of domestic manufacturing firms

- **Allowing foreign entry appears to be the key channel** through which services liberalization may affect performance of downstream manufacturing sectors

- A one-standard-deviation increase in FDI in services => a **7.7%** increase in the average productivity of Czech firms in downstream manufacturing

Arnold and Javorcik (JIE 2011)

Evidence from India

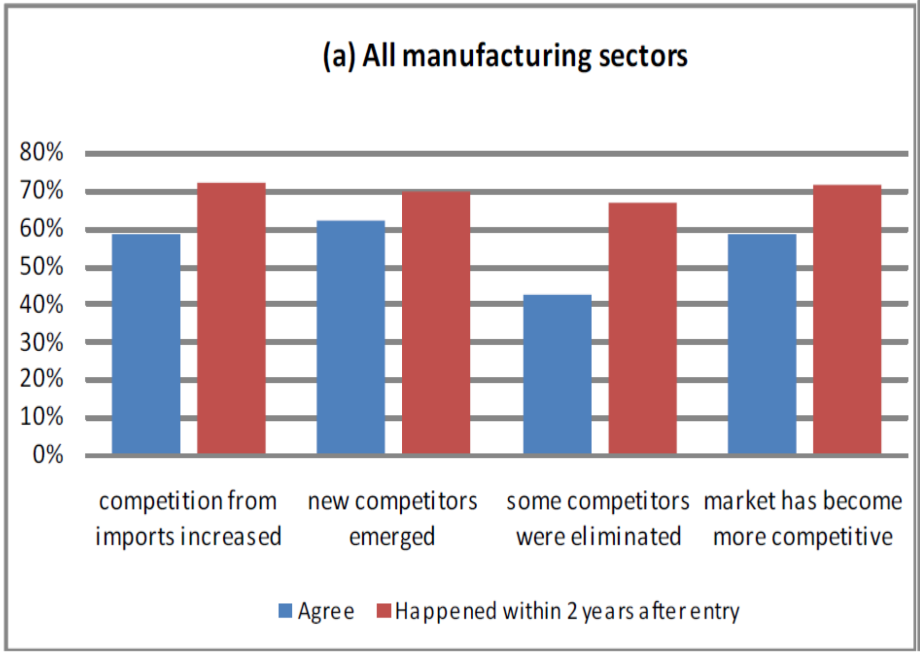
- A one-standard-deviation change in the services reform index corresponds to the following increase in productivity of manufacturing firms
  - banking 6.6%
  - telecommunications 8.4%
  - transport 18.8%

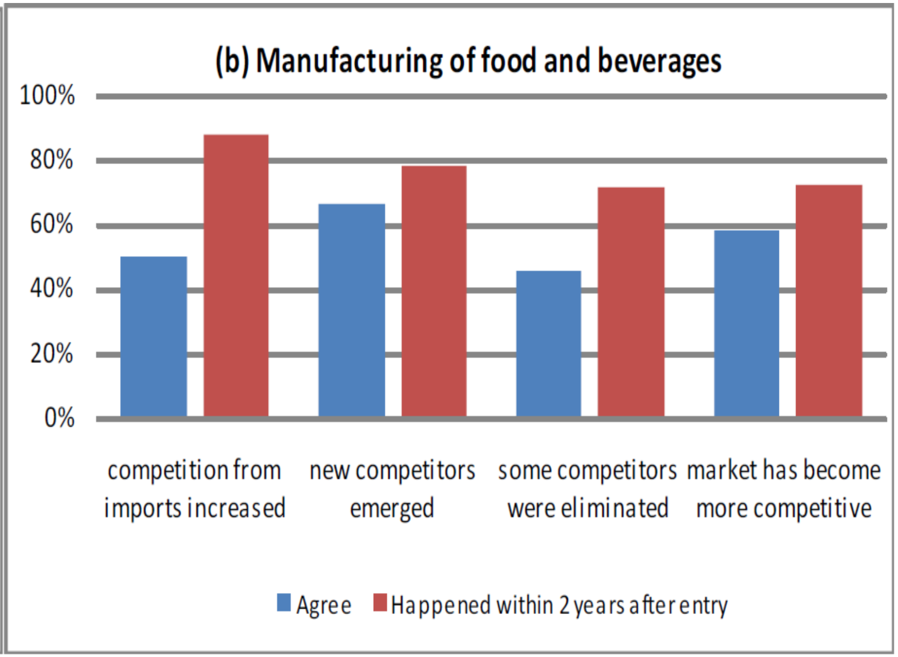
Arnold, Javorcik, Lipscomb and Mattoo (2012)

Global Chain in Romania:
Regional Distribution 1997

Global Chain in Romania:
Regional Distribution 2005

What were the effects of the entry of foreign retail chains on the market in your city?





Evidence from Romania

- The opening of the retail sector to FDI has stimulated productivity growth in upstream manufacturing in Romania
- Presence in a region increases TFP by 3.8-4.7%
- The effect took place through within firm productivity growth and reallocation

Javorcik and Li (JIE 2013)

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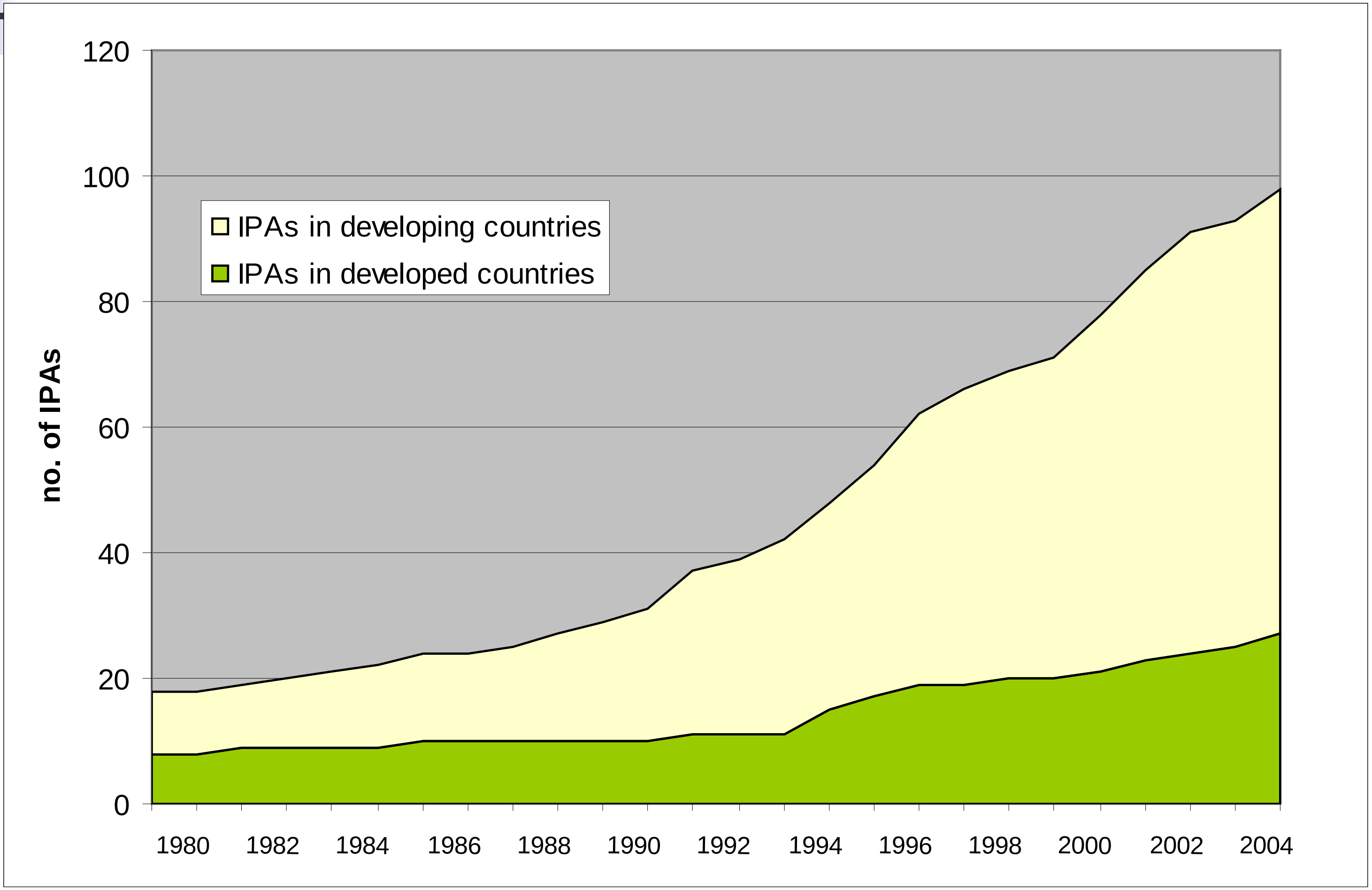
Why do investment promotion?

- Knowledge externalities as justification for policy intervention
- Information asymmetries between host countries and potential foreign investors are significant obstacles to investment flows across international borders
- What can aspiring FDI destinations do to reduce such barriers?
- Is investment promotion the answer?

Almost all countries are engaged in FDI promotion



Harding and Javorcik (EJ 2011)

- Conducted a Census of IPIs on behalf of the World Bank
- Point of departure
  - Sector targeting considered best practice in investment promotion
- Information on sector targeting
  - Standardized list of targeted sectors with dates when the policy was in place
- Data on FDI from the U.S. by country, sector and year
  - (124 countries, 15 sectors, 1990-2004)
- **Did FDI inflows to targeted sectors increase during targeting?**
  - (relative to non-targeted sectors)

Estimation results

- Investment promotion generates higher FDI flows to developing countries and emerging markets:
  - Targeting increases FDI by 155%
  - Additional $17 mn dollars of FDI

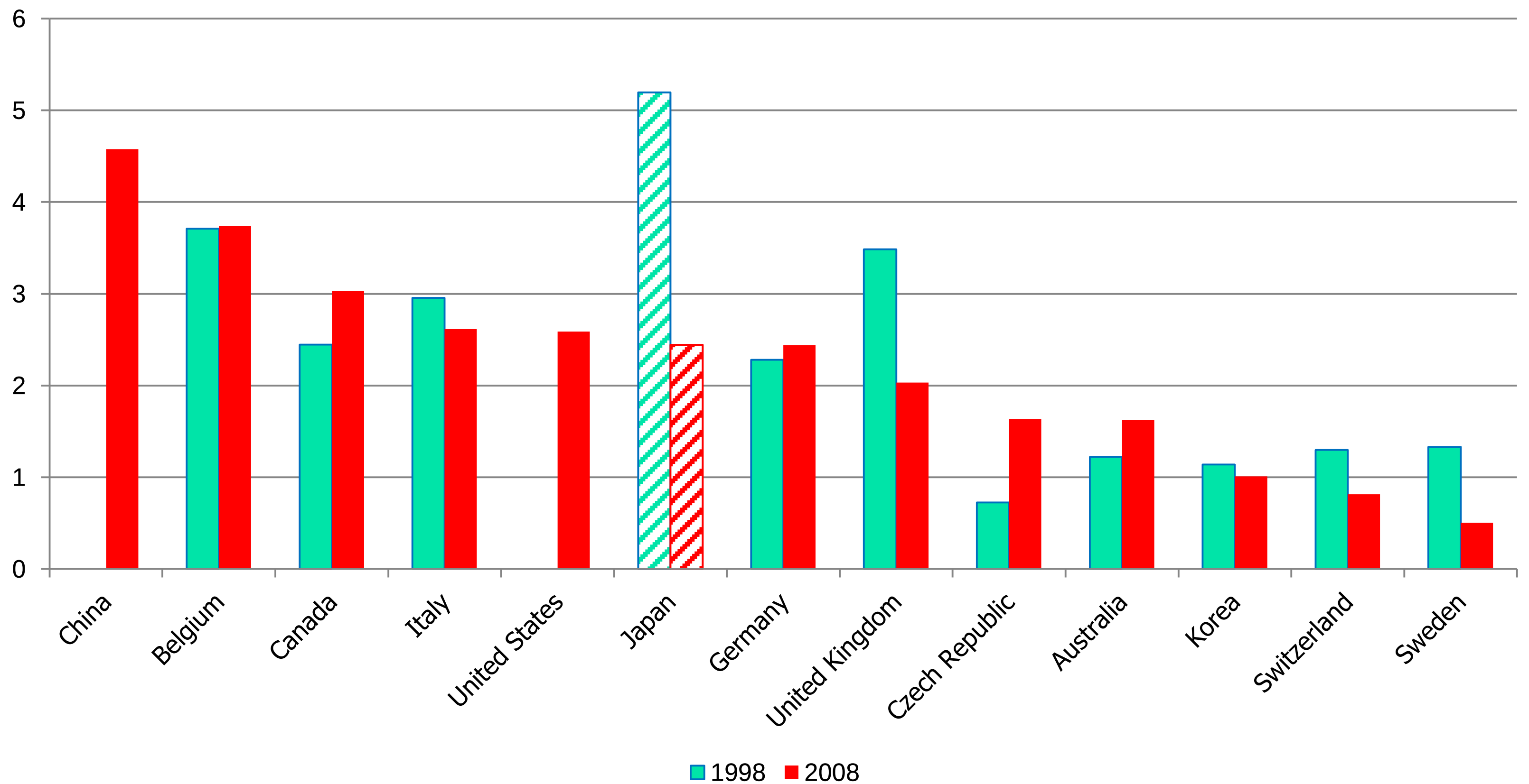
- Investment promotion does not appear to be effective in industrialized countries

- Investment promotion has a larger impact in countries...
  - where information asymmetries are large
  - with burdensome bureaucratic procedures

Policy conclusions

- FDI is good for growth
- Investment promotion is effective in emerging markets, but less likely to be so in industrialized economies
- Stay away from FDI subsidies
  - No evidence that they work (Harding and Javorcik 2011)
  - Easy to overpay (an affiliate operating for 10 years => benefits of £18,841 per job – Haskel et al. 2007)
- Liberalize services industries

Restrictions in the retail sector
(OECD index)



Thank you

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