



FDI and Economic Development

Attracting **foreign direct investment** (FDI) is becoming an increasingly popular option for developing countries trying to improve the economic lots of their citizens in the current **neoliberal** regime. But are there good reasons for developing countries to encourage FDI in particular, rather than, say, giving more incentives to domestic investors? In other words, is foreign direct investment good for development? This brief will address three aspects of this issue: the impact of FDI on a **host** country's **productivity**; investment by local firms; and wages and employment.

FDI and Productivity Growth

In addition to the direct effects that FDI has on economic growth by increasing overall investment in a country, an effect that could just as easily be fulfilled by government or local investors, why might FDI in particular be considered so attractive to developing countries? Of course, there are many reasons, but most of them have to do with the fact that foreign investors bring with them advanced technology and ideas, with the potential to contribute to the host country's economic growth in much greater

ways than FDI's direct effect on economic growth. One way this can happen is through what economists term "spillover effects," when, for instance, an advanced production process brought in by multinational corporations (MNCs) spills over into the rest of an industry and increases the efficiency of domestic producers.

Thinking about this from an economic perspective, the question is really an empirical one. So, what's the empirical evidence? Well, economic studies on the **productivity**-enhancing effects of FDI in developing countries are numerous. But in a recent review of these studies by economist Gordon Hanson for the United Nations, it was found that many of these studies are not very good ones, mostly because the data used do not accurately measure the impact of FDI on productivity. More recent work that considers the issue by looking at the effects of multinational presence on *particular* firms in Morocco and Venezuela find that multinational corporations have in fact had a negative effect on the productivity of domestic firms in the same industry, suggesting that MNCs may confine competing domestic firms to less profitable segments of industry.

FDI and Domestic Investment

Whether or not FDI contributes indirectly to growth through productivity, there is still the question of how it may affect domestic investment, whether FDI stimulates (“crowds in”) or crowds out domestic investment. In a background paper for the United Nation’s *World Investment Report*, an annual publication that is an industry standard for following FDI, economists Manuel Agosin and Ricardo Mayer did an empirical study of whether foreign investment crowds in domestic investment using information for three developing regions: Asia, Africa, and Latin America. Their results indicate that for the period 1970-1996 as a whole, there is crowding in of domestic investment in Asia and crowding out in Latin America. In Africa, the effects of FDI have been neutral in the sense that they have not crowded in nor crowded out domestic investment. They conclude, then, that the impact of FDI on domestic investment is not always positive and that simply pursuing FDI as a development strategy is unlikely to deliver the best results. Policies towards FDI must be closely managed (as they have been in Asia), otherwise MNCs can end up constraining the growth of local industry.



Wages and Employment

There are three main arguments in economics about the effects of FDI on wages: (1) that FDI leads to increases in the demand for labor, thereby raising wages because workers get more scarce; (2) with greater technological know-how, especially in developing countries, MNCs exhibit higher productivity (as discussed above) and can pay their workers more, an impact that could spill over into the rest of the economy and raise overall wages; and (3) because capital is internationally mobile and labor is not, FDI may enhance capital’s bargaining power relative to labor, thereby lowering wages.

Some interesting but limited work has been done on these issues for developing countries. Looking at the period 1968-1993, economists Eva Paus and Michael Robinson find that FDI does have a direct positive impact on wages in developing countries, but that this positive impact is true only for the period 1968-87. This work suggests that the increasing mobility of international capital since the late 1980s has enhanced capital’s bargaining power relative to labor, dampening the potential positive impact that FDI can have on wages. In a comparative study of Mexico, Venezuela, and the

United States, economists Brian Aitken, Ann Harrison and Robert Lipsey find that higher levels of FDI are associated with higher wages in all three countries, but in Mexico and Venezuela, this association was limited to foreign-owned firms, indicating a lack of evidence for the hypothesis that higher wages in MNCs spill over into domestic firms.

So the evidence on how FDI impacts wages in developing countries is not all that positive. On the one hand, there is some indication that FDI can indeed raise wages, at least to the extent that MNCs tend to pay their workers more than local firms do. But there is no evidence that this effect spills over to the rest of the economy, raising wages overall. In fact, other studies of FDI in developing countries that focus on wage inequality have found that FDI is associated with an increase in wage inequality within countries because MNCs pay their workers more.

Conclusion

So in thinking about the issue of whether FDI is good for development in ways that domestic investment is not, it seems that the evidence is weak, at least in terms of the issues discussed here. There are other factors to consider, like whether MNCs encourage exports. But it is clear that the blind pursuit of FDI is not likely to result in net benefits for development, and that carefully considered policies must be implemented to capture the potential positives of foreign investment. The current trend in international investment treaties, towards more and more liberalization and constraints on government controls, is contrary to this goal.

Sources:

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