Foreign Direct Investment in Developing Countries:

Leveraging the Role of Multinationals

Edited by
Serge Perrin and Frédérique Sachwald

Agence Française de Développement
Institut Français des Relations Internationales

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5 rue Roland Barthes - 75598 Paris cedex 12

Tél : 33 (1) 53 44 31 31 - Fax : 33 (1) 53 44 99 39 - Internet : www.afd.fr

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Introduction

FDI and Development : The Policy Issues Ahead

Serge Perrin
Research Department, AFD

and Frédérique Sachwald
IFRI and CEPN

Booming FDI has been a major feature of globalisation since the 1980s. FDI decreased sharply in 2001 and 2002 after the Internet bubble burst, but global flows are still far higher than at the beginning of the 1990s. The geographical composition of FDI has remained relatively stable with the bulk of flows still being directed to developed countries. Developing and transition countries have nevertheless received increasing amounts of FDI. Moreover, they represent a larger share of greenfield flows since FDI in developed countries often results from mergers and acquisitions. The fact that FDI is concentrated on a limited number of developing countries means that some have received very large amounts, China being the most impressive case. Some less attractive countries have nevertheless experienced a substantial increase in their inward FDI flows. Even the group of less developed countries has attracted larger FDI flows over the last decade. This

trend is often missed as they represent a declining share of total inflows to developing countries, which have been increasing at an even faster rate.

The increase in FDI to developing countries has to be related to the deepening economic integration brought by globalisation. Their participation in international exchanges, including trade and FDI in particular, has generally increased. As a result, a larger number of developing countries have become integrated into global production networks, which has facilitated their access to not only financial resources, but also technology and foreign markets. This has been the case, most remarkably, for a number of previously closed countries such as China, India or Vietnam.

In the 1960s and 1970s, numerous developing countries' governments developed foreign investment codes to restrict inflows in an effort to reduce remittances of dividends or to protect local firms. In the 1980s, after decades of scepticism or even hostility, the belief developed that multinationals could be an important element in a country's development strategy. As a consequence, governments around the world in both advanced and developing countries have been wooing multinationals. This change should be viewed in the broader context of liberalisation in which most developing and transition countries have moved to market-oriented strategies. Governments' changing attitudes towards multinationals may nevertheless be considered as the most striking policy change in developing countries, which has to be traced to the radical reappraisal of the role of FDI in local development.

The potential benefits of FDI

Recent analyses emphasise the role of the creation and diffusion of productive knowledge in the process of growth and development. These new theoretical perspectives, where learning and the upgrading of indigenous human capital play a central role, provide a convenient framework for analysing the relationship between FDI and growth. Indeed, many of the growth-promoting factors (human capital, externalities, etc.) highlighted by the new theory are supposed to be enhanced by FDI. In particular, FDI has considerable potential to transfer ideas from advanced to developing countries and hence to increase productivity in the latter.

From this perspective, FDI is a major channel through which latecomer countries can effectively exploit the international pool of existing technologies available from foreign leaders. As a result, many countries have adopted less restrictive policies *vis-à-vis* technology transfers and try to attract FDI, hoping that knowledge brought by multinationals will spill over to domestic industries and increase their productivity.

It is thus of crucial importance to policy-makers to understand whether and under which conditions FDI effectively contributes to technology transfer and development. The local environment in particular may influence the effectiveness of the different channels through which FDI is supposed to have a positive impact. For example, the type of interactions between multinationals and local firms determines the extent to which backward linkages with suppliers constitute an effective channel for technology transfer. In turn, these interactions depend on a host of local characteristics, such as regulations on local content or the competitiveness of local

suppliers. Competitive and variegated local suppliers of intermediate goods and components are a real asset in terms of stimulating technology transfers and learning. On the contrary, strong concentration or weak suppliers reduce positive spillovers from foreign affiliates.

Conditional benefits and policy implications

Results from various studies indicate that FDI can play a very effective complementary role in the process of development, provided that countries tailor their own capabilities in order to harness the potential of global markets and production networks.

Many factors and policies can influence the extent of the benefits and costs of inward investment. Recent empirical studies have yielded new insights on a number of issues, even though some areas are still being explored. One central finding has been that effective contribution of FDI to domestic growth and technological upgrading depends crucially on the economic and institutional context in the host country. In particular, effective knowledge transfer is facilitated if the recipient firms possess an adequate absorptive capacity. This means that local firms have to invest in human resources and develop learning efforts. At the national level, it means that the exploitation of external technology and productivity spillovers depend on the accumulated stock of human capital in the host country. A number of studies have further suggested that there is a threshold effect of human capital, or income, under which FDI makes no significant contribution. Estimates of the level of this threshold may vary according to host country and industry characteristics, and to sampling differences and

methodologies. Nevertheless, a « sufficient » local learning capability appears to be a prerequisite for assimilating the more advanced technologies introduced by multinational enterprises (MNEs) in the host economy.

Human capital is a major component of the host country's absorptive capacity, which plays a crucial role in maximising the positive impact of FDI. Absorptive capacity also depends on a number of other factors, including the soundness (and depth) of the financial system, the orientation of the trade regime, the quality of physical infrastructure, the broad macroeconomic policy framework, political stability, the efficiency of government services and the degree of corruption. There may also be threshold levels for these various factors below which foreign investment has no significant effect.

Empirical studies also suggest that the impact of FDI depends on the duration of MNEs' activities in a country. For example, the initial impact of Japanese affiliates' operations in Asia has been limited. Japanese MNEs were newcomers in the late 1970s relative to their US counterparts, and were more interested in selling to the developing host countries and thus in transferring the manufacturing of final goods in simple technology industries, whereas US affiliates relocated production of intermediate goods for home consumption, thereby boosting host countries' exports. Over time, Japanese firms have matured and behaved more like US MNEs, implementing global production networks linking their subsidiaries in home and host countries vertically and thus transferring more technologies. Japanese MNEs have become more willing to exchange with local companies and adopt a co-operative approach with their Asian production networks.

The role of public policies in leveraging the effects of MNEs

Since the 1980s, the attitude shift towards FDI may have led host country governments to expect too much from multinationals and could have exacerbated investment wars through which potential hosts try to woe FDI away from other countries. For example, subsidies may lure some foreign firms but are not sufficient to promote either their extensive co-operation or to ensure spillovers. Rather, host countries should devise lucid policies that aim at maximising the benefits and minimising the costs of incorporating FDI into their development strategies.

Empirical studies suggest that foreign units that are tightly integrated into the global networks of the parent company tend to generate more technology transfers and spillovers in host countries. This suggests that host countries should allow parent companies to choose the characteristics of their affiliates, including in particular full ownership and the extent of technology transfers. Such an attitude constitutes a « paradigm reversal » for authorities in developing countries, where traditional policies aimed on the contrary at controlling foreign units to ensure that their behaviour would benefit the host country. The previous paradigm was consonant with a whole set of policies aimed at promoting import substitution in a techno-nationalist perspective. In the context of globalisation, broader policies have evolved away from import substitution strategies, and it may seem logical that FDI policies are also changing.

The prospective benefits from changes in rules influencing FDI directly should be enhanced by changes in the general business environment aimed at strengthening the rule of law and market institutions. For example, empirical studies show that corruption and weak

intellectual property regimes tend to reduce the amount of FDI flowing into a country and to attract lower quality projects. More generally, the literature strongly suggests that multiple interactions exist between market institutions and policies that influence investment, which implies that reforms should probably target different areas. Numerous studies have thus underscored the fundamental role of government policies in fostering investment in generic immobile assets, including first basic education and training more broadly. Infrastructure, including in information and telecommunications, is also very important. Even least developed countries can take advantage of such generic policies to attract FDI and leverage foreign investment to meet national objectives.

Host countries should carefully strengthen their absorptive capacity. Relevant policy areas include education, training and the innovation system. Adequate policies to upgrade the local absorptive capacity are required to maximise the spillovers and positive effects of FDI in all productive activities and not only in high-tech sectors. The relevant sets of policies should be integrated into the national development strategy rather than considered as specifically aimed at foreign investment. In the 1960s and 1970s, domestic technology policy was most often separate from technology import considerations, or was weak and undeveloped. Recent studies suggest on the contrary organising close interactions between technology transfer and national innovation policies. Such a perspective would help integrate foreign companies' operations into the local business environment, which would become more transparent and predictable for all types of companies.

It is in this perspective that AFD and IFRI held a workshop on 10 June 2004 in Paris, which brought together economists from various countries and aimed at discussing recent empirical studies on the determinants and impact of FDI in developing countries [1]. The main focus was on the institutional context to attract FDI, including at the sub-national level, the role of regional policies and export processing zones.

Attracting FDI : the influence of the institutional context

In chapter 1, Rodolphe Desbordes, Céline Azémar and Jean-Louis Mucchielli analyze the role of public governance as a determinant of FDI in Sub-Saharan Africa and South-East Asia. Recent studies emphasise the importance of institutional factors - along with the conventional variables such as market size or labour costs - as prerequisites for attracting FDI. Various indicators for measuring « good governance » and the quality of institutions are now available, and are often subject to controversy. In order to improve the assessment of the institutional environment, the authors have developed a new composite index, which incorporates four dimensions of public governance : political, civic and economic freedom; public goods; macroeconomic policies, and socio-political instability. They find that governance matters and helps to explain the diverging abilities of Sub-Saharan Africa and South-East Asia to attract FDI over the 1976-1995 period. Foreign investors have a clear preference for countries with outward-oriented policies and a high provision of

1. This is a follow-up to our previous paper: *Multinationales et développement: le rôle des politiques nationales*, Notes et Documents, N°2, Agence Française de Développement [www.afd.fr]. In English, see " FDI in Developing Countries ", *TIK Working Paper*, N°14/02, University of Oslo (downloadable on www.ifri.org).

public goods (education, health, telecommunications). However, the freedom and socio-political instability factors do not exhibit a significant influence on FDI inflows. This suggests that the returns on investment in these regions were sufficiently high and offset the political risks. In Sub-Saharan Africa, the importance of FDI for natural resources – which are highly dependent on the nature of the relationship with the host country government - explains why multinational enterprises may have invested despite authoritarian regimes. The results may differ somewhat if FDI in extractive industries is excluded from the empirical analysis.

The institutional context matters not only at the national level, but also at the sub-national level and can be examined through the role of export processing zones (EPZs). The primary goals of an EPZ are to provide foreign exchange earnings by promoting exports, spur employment, attract FDI and accelerate technology transfer. But opponents believe that the costs of maintaining special economic zones are not offset by benefits (*e.g.* spillovers) to the rest of the economy, and may favour corruption. Edward Graham contributes to this important debate for policy makers and draws some lessons in light of China's experience (chapter 2). He argues that EPZs in China should be counted as a major success, not only because they generated new exports and employment but also because they stimulated further reforms that boosted economic growth during the 1990s. He suggests that other developing countries, such as India, may also benefit from the creation of EPZs provided that reforms are strongly supported by a faction within the nation's leadership. Two additional lessons can be drawn from the Chinese case: first, multiple zones should be established and allowed to compete with

one another in order to « contain corruption at levels that do not create total dysfunction », and second, an EPZ located in a depressed region has little chance of fostering development.

The influence of sub-national institutions is further explored in the case of Vietnam (chapter 3). Klaus Meyer and Hung Vo Nguyen argue that decentralisation of administrative responsibilities has created opportunities for entrepreneurially-minded local authorities to further economic reform and thus foster the development of both local businesses and foreign investment. They show that the substantial variation of FDI within Vietnam is to a large extent induced by the diverse development of informal institutions and the uneven implementation of reform initiatives. Decentralisation can lead regions to compete for FDI, but also the central government to roll out the « red carpet », while bureaucrats in ministries or local authorities create « red tape ». Decentralisation of FDI-related responsibilities thus requires the development of supporting institutions at the local level. Other developing countries facing unequal FDI distribution, such as India and China, should be concerned about attracting foreign investors to other locations, and may also benefit from more decentralisation of decision-making to local authorities.

Assessing FDI's contribution to development

Chapters 4-7 address the issue of FDI's contribution to development through various regional (East Asia, Sub-Saharan Africa) and country (South Africa, Morocco, Tunisia) experiences, which have been relatively little studied so far.

Although there is a widespread belief that FDI may support development in the aggregate, there has been little empirical work

specifically focusing on its effects on inequality or poverty. One cannot simply assume that FDI will contribute to alleviate poverty through fostering economic growth. Dirk Willem te Velde and Oliver Morrissey (chapter 4) argue that the benefits from FDI are not equally distributed : foreign-owned firms tend to pay higher wages in developing countries but skilled workers tend to benefit more than less-skilled workers, thereby increasing wage inequality. This conclusion is based on research conducted into the effects of FDI on wages in five East Asian countries (Hong Kong, Korea, Singapore, Thailand, Philippines) and the effects of foreign ownership in five African economies (Cameroon, Ghana, Kenya, Zambia, Zimbabwe). Technologies used in foreign-owned firms may be more skills-biased than in local firms, and skilled workers in foreign firms may be more effective at bargaining. Among the various implications derived from this research, policy should notably (i) be aware of whether wage inequality induces national income inequality, and (ii) invest in appropriate human resources and general training for low-skilled workers to maximise the benefits of FDI.

The impact of FDI on labour markets is further explored in the case of South Africa (SA). High unemployment – about a third of the working age population is not economically active – and low domestic savings have induced a shift toward more liberal and outward-oriented policies in the 1990s, in part to attract new FDI. But according to Stephen Gelb (chapter 5), new FDI into SA, driven primarily by merger and acquisition activity, has been lower than anticipated and has had a limited impact on employment creation. As a result, it is not likely to drive medium-term growth. Nevertheless, it has contributed to skills upgrading, particularly

among high-skilled blacks (nearly half the foreign affiliates surveyed had black executive managers in 2000 compared with only 17% at entry), and may be worsening the skills bias and growing inequality in the labour market. Sectoral studies suggest that FDI contributes to the globalisation of South African manufacturing through exports but remains limited in scale (clothing) or scope (autos). Stephen Gelb finds little evidence that new domestic firms have emerged to exploit market opportunities. Since the focus of his research is on recent FDI (*i.e.* after 1990), the question is whether spillovers will accrue over the long-term. Foreign investors may also contribute to regional integration as their market orientation includes South Africa's regional hinterland ; interestingly enough, SA firms are increasingly a part of this process and are emerging as a source of FDI to other Sub-Saharan Africa countries. This suggests that some SA firms have developed ownership advantages enabling them to invest overseas ; the nature and the extent of this phenomenon should be further explored and would make an interesting contribution to the literature on « Third World Multinationals ».

Chapters 6-7 examine the role of FDI in two MENA (Middle East and North African) countries, Morocco and Tunisia. Although this region has typically lagged behind other developing economies in attracting FDI flows (capturing only 2% of FDI flows to developing countries), these two countries have been relatively more favoured by foreign investors, notably from Europe, in search of a lower-cost production base close to the European market. In 2003, according to UNCTAD data, FDI stocks represented 26% and 66%, respectively, of GDP in Morocco and Tunisia. Jamal Bouoiyour (chapter 6) first compares the characteristics of Moroccan and foreign manufactu-

ring firms between 1987 and 1996, and finds, as expected, that the latter perform better in terms of productivity, are technologically more advanced and more export-oriented, and pay higher wages than the former. Second, based on ongoing research, J. Bouoiyour suggests that foreign presence may have a positive impact on Moroccan productivity but that the relationship depends on local absorptive capacity or the technological gap (*i.e.* distance between foreign and local firms in terms of total factor productivity). It would appear that the larger the technological gap, the greater the spillover, up to a certain point. One interesting implication is that the effects of FDI may vary greatly across industries. This line of research deserves further investigation and may call for more appropriate sectoral policy response to foster spillovers between foreign and local firms.

In the final chapter, Jean-Raphaël Chaponnière and Serge Perrin focus on the role of FDI in the Tunisian textile and clothing industry (T&C), which is about to face a major challenge with the expiration of the Multifiber Agreement in 2005. T&C still plays a prominent role in the Tunisian economy, accounting for half of industrial employment and exports. The strong presence of foreign investors in this sector is rather unusual, as the most common form of globalisation of T&C is more trade-related (through outsourcing) than FDI-related. In Tunisia, FDI affiliates represent about half of the 2000 enterprises and 200,000 persons employed in this sector. Apart from labour costs and geographic proximity, the promotion of an offshore regime since the 1970s - which notably offers generous financial incentives to fully-exporting enterprises – has enhanced Tunisia's attractiveness. As to the impact issue, FDI does

contribute significantly to private investment, exports and employment in T&C, but is not very integrated into the rest of the economy. Foreign firms import most of their inputs and there is little prospect of increasing local sourcing due to problems of delays and low quality. On the demand side, the potential of the local market has also been neglected. Tunisia has not climbed up the value chain in T&C : the country has not invested in the textile and finishing industry and is still heavily dependent on subcontracting. It may be too late to consider that FDI can facilitate the move up the value chain. Tunisia may nevertheless remain competitive in the near future in some medium- and high-quality niche markets.

Overall, these empirical studies do confirm the usefulness of examining the role of the institutional context in order to assess the impact of FDI on local firms and economies. They point to some clear policy conclusions, but also highlight the complexity of some issues due to specific sectoral and regional characteristics. Some papers thus point to the need for further research in order to fully assess the impact of FDI in developing countries.

Chapter 1.
Public Governance as a Key Determinant of FDI : *A Comparative Analysis of Sub-Saharan Africa and South-East Asia Host Countries*

Rodolphe Desbordes, Céline Azémar
and Jean-Louis Mucchielli *
TEAM, Université Paris I-Panthéon-Sorbonne

1. Introduction

The World Bank (2000), in its report on « Quality of Growth », emphasises the importance of public governance as the keystone of a country's development. Studies examining determinants of foreign direct investment (FDI) are also increasingly taking account of such fundamentals as institutional and political factors. Thus, rule of law, bureaucratic corruption, educational attainment or quality

* This article is a short version of Desbordes *et al.* (2004). Corresponding author. E-mail address: rodolphe.desbordes@univ-paris1.fr. University of Paris I, Panthéon-Sorbonne. Maison des Sciences Economiques, 106-112, Bd. de l'Hôpital, 75647 Paris cedex 13, France. E-mail addresses: celine.azemar@malix.univ-paris1.fr and jlmuc@univ-paris1.fr

of physical infrastructure are now included in econometric analyses next to more common variables such as market size, labour costs or trade openness. In other words, good governance appears to be a key condition for attracting FDI. For instance, Lehmann (1999), shows that a country like India could increase its share of US affiliates' physical investment by 50% if it were to eliminate all political uncertainty.

For a developing country, the stakes for improving its public governance are high. Beyond an increase in its growth rate, a favourable business climate is likely to attract more FDI and enhance their alleged spillovers. More FDI means more financial resources for the host country, whereas it is likely that the technological intensity of these investments and the transfer of foreign know-how to domestic firms will largely depend on the quality of public governance.

This article has three goals. First, to clarify why public governance is likely to influence FDI inflows. Second, to propose a new evaluation of public governance through the construction of quantitative, relatively objective, easily replicable and sample-specific indicators. The public governance of two geographic zones will be assessed through this method: Sub-Saharan Africa (SSA) and South-East Asia (SEA). As shown in table 1.1, the former attracts much less FDI than the latter. Third, to test econometrically whether public governance explains the diverging abilities of SSA and SEA to attract FDI.

The paper is constructed as follows : section 2 examines the theory behind the potential influence of public governance on foreign direct investment and compares the governance conditions in SEA and SSA, through the use of self-made public governance indicators. Section 3 tests econometrically which governance

Table 1.1
Distribution of FDI flows throughout the world, 1980-2001

	Inward FDI (%)	
	1980	*2001*
Developed countries	**84.3**	**68.4**
Western Europe	39	45.7
North America	41	20.7
Other developed countries	4.3	2
Developing countries	**15.6**	**27.9**
Africa	1	2.3
Sub-Saharan Africa	0.4	1.6
Latin America and the Caribbean	13.6	11.6
Asia-Pacific	0.9	13.9
South, East and South- East Asia	6.5	12.8
Central and Eastern Europe	**0.1**	**3.7**

Source: UNCTAD World Investment Report 2002 and UNCTAD FDI/TNC database: http://stats.unctad.org/fdi/

indicators have an influence on foreign direct investment flows and how well public governance explains the diverging attractiveness of SEA and SSA. Section 4 concludes.

2. Theory of Public Governance : Impact on Foreign Direct Investment

2.1 Public governance: definition, impact on foreign direct investment and statistical evaluation

Kaufmann *et al.* (1999) define public governance as « the traditions and institutions by which authority in a country is exercised » (p.1). Five dimensions of government performance can be outlined :

a) Freedom and political stability

b) Provision of public goods

c) Macroeoconomic policy

d) Property rights and contract enforcement

e) Corporate governance.

Each can help create a satisfactory business climate for foreign investors, as follows :

a) Freedom and political stability

Political freedom corresponds to the right of citizens to choose, monitor and replace the people in power. Freedom of expression, assembly, association (including business activity), religion and oppression can be classified under the heading of civil liberties. Nevertheless, freedom does not necessarily imply political stability, which can be defined as frequent regular or irregular changes in the government in power, through peaceful or violent

means and by the existence of checks and balances constraining the Executive.

Political instability in countries is likely to deter FDI inflows because the legal environment is unpredictable. As the future is uncertain, firms may prefer to wait for new information. Moreover, democratic countries stand a better chance of attracting FDI because this political system tends to favour a more stable and transparent business climate in the long run (Rivera-Batiz, 2001 ; Rodrik, 1999) and because multinational companies are increasingly reluctant to invest in a repressive regime, so as to preserve their brand name and image (Letnes, 2002).

b) Provision of public goods

As La Porta *et al.* (1999) point out, government plays a large role in delivering health, education, infrastructure, particularly when the use of these goods cannot be confined to certain individuals. The efficiency of its interventionism depends largely on its bureaucracy, which can be seen as another public good (La Porta *et al.,* 1999 ; Rauch and Evans, 2000). Health and education enhance a worker's productivity and therefore lower the efficiency wage rate, *i.e.* the absolute wage rate deflated by the productivity of labour force. A positive link might therefore arise between the location of multinational firms attempting to take advantage of international differences in factor prices, and these public goods. Carr *et al.* (2002) offer two other explanations. First of all, it is likely that the setting-up of a foreign plant will require a certain amount of skilled labour. Furthermore, human capital should be correlated with other FDI determinants, such as physical and institutional infrastructure.

Pro-business measures, including reductions in bureaucratic « red tape » and corruption, are seen as increasing determinants of foreign direct investment flows (Mallampally and Sauvant, 1999). Conversely, burdensome and lengthy administrative procedures required to establish and operate a business are likely to discourage FDI. Likewise, there may well be a strong correlation between administrative costs and bureaucratic corruption, since public officials may impose these excessive regulations on multinational companies to extract rents from them. Indeed, as explained by Wei and Wu (2001), « the need for international investors to pay bribery and deal with extortion by corrupt bureaucrats tends to increase with the frequency and the extent of their interactions with local bureaucrats » (p5). Foreign investors are therefore confronted with an additional tax, whose rate is uncertain (Wei, 1997).

c) Macroeconomic policy

The goal of a macroeconomic policy is to maintain the internal and external balance of the macroeconomic system (Krugman and Obstfeld, 2001) . The internal equilibrium refers to the full use of the factors of production and to price stability. The external equilibrium implies that the trade balance is high enough to allow the country to pay back its foreign debts.

FDI is unlikely to flow to economically unstable countries as they do not offer a stable and predictable business environment and because the deterioration of internal and external macroeconomic indicators, *i.e.* inflation and trade balance, may engender higher taxes and capital controls as well as the increased use of import barriers, probably reducing the expected profitability of a foreign investment.

d) Security of property rights and contract enforcement

North (1990) defines property rights as « the rights individuals appropriate over their own labour and the goods and services they possess. Appropriation is a function of legal rules, organizational forms, enforcement, and norms of behaviour — that is, the institutional framework » (p.33). The creation, protection and enforcement of property rights are particularly important because without them the scope for market transactions is limited (World Bank, 2002). North (1990) and more recently Clague *et al.* (1999) have emphasised the need for third-party enforcement when transactions are not simultaneous. Because the market has clear limits when it comes to enforcing contracts, this role is devolved upon the government, notably through its judiciary system. However, this authority also possesses the power to expropriate agents.

Foreign investors demand protection of their property rights, especially when their ownership advantage lies in their technological level. Otherwise, they are denied the return on their investment, which means that without this profit incentive, they will not be inclined to take a risk and invest in the potential host country (Drabek and Payne, 1999). Furthermore, whenever their property rights are threatened and their contracts violated, multinational companies must be able to quickly settle their disputes through the legal system.

e) Corporate governance

Corporate governance relates to the regulatory settings for a firm's decision-making. For the OECD (1999), good corporate governance implies (1) the protection of shareholders'rights ; (2)

equitable treatment of shareholders, including minority and foreign shareholders ; (3) recognition of the stakeholders'rights ; (4) timely and accurate disclosure on all material matters regarding the corporation ; (5) a responsible board that is fully informed and accountable to the company and shareholders. Corporate governance can be associated with public governance as it is the government's duty to ensure that the proper rules have been enacted and that they are adequately enforced by independent authorities.

FDI is likely to be drawn towards countries offering a strong corporate governance framework for at least two reasons. First, weak corporate governance may fuel economic instability (Acemoglu and Johnson, 2002). Second, FDI is increasingly taking the form of cross-border mergers and acquisitions (M&As) [4], and it can therefore be expected that the quality of corporate governance plays a role in the acquisition decisions of multinational companies.

2.2. A review of indicators of public governance and institutional quality

Most studies on the performance of public governance use subjective indexes which are based on polls of experts (Business International, International Country Risk Guide, Business Envi-

4. Indeed, according to UNCTAD (1999) " available information suggests that cross-border M&A activity has accounted for between one-half and two-thirds of world FDI flows in the 1990. The figure is higher for developed than for developing countries, but the difference is principally due to the smaller role of M&As in China. If China is excluded, the share of M&A in cumulative FDI in 1992–1997 turns out to be 72 per cent, up from 22 per cent during 1988–1991. […] Thus, the recent boom in FDI flows to developing economies has, with the exception of China, consisted predominantly of M&A, largely in the services sector " (p 118). In these countries, this phenomenon has been largely driven by privatisation programmes, such as in Latin America (*ibid.*., p118). In 2002, privatisations still accounted for 60% of the value of M&As (World Bank, 2003, p.86).

ronmental Risk Intelligence, Freedom House) or cross-country survey of firms (World Development Report, 1997). Some disadvantages with using this type of indicators can be pointed out. Most of them are obviously not freely available and logically select the countries in which foreign investors are most interested. The accuracy of a country's rating depends on the knowledge of the expert(s) assessing it. Moreover, evaluators may be influenced by a country's recent economic performance when they evaluate its institutional efficiency. Indeed, Chong and Calderon (2000) found a two-way causality between institutional quality (BERI or ICRG indexes) and growth rate. Finally, commercial country risk indexes tend to assess developed and developing countries and therefore contrast the latter with the former; as mentioned by Morisset (2001), African countries tend to be concentrated at the bottom of commercial rankings.

2.3 A comparative numerical analysis of public governance in South-East Asia and Sub-Saharan Africa

2.3.1. Methodology and data used to measure governance aspects

In order to create indexes measuring the different dimensions of public governance, principal component analysis will be used. This is a statistical technique for data reduction as the objective is to find the unit-length linear combinations of the variables with the greatest variance. This method should help by creating weighted indexes that are not biased by the researcher's subjective choices. Furthermore, given the presence of multicollinearity, it makes sense to form a composite index. Finally, the ranking that will be

generated in this way will have the advantage of being specific to the sample used ; African and Asian countries will be compared to each other, on the basis of available statistical information.

Four dimensions of public governance will be evaluated with a principal component analysis : [5]

a) Political, civic and economic freedom

b) Public goods

c) Macroeconomic policies

d) Socio-political instability.

The variables, described below, were chosen on the basis of their relevance and spatial/temporal availability (table 1.2). As is well-known, statistics on developing countries, especially African nations, are scarce.

Two periods are observed: 1976-1985 and 1986-1995 [6]. The calculations have been made with the two time spans included, in order to be able to track the evolution of public governance conditions. Each index has been rescaled from zero to ten. A public global governance index has been computed such as :

Public Governance Index = (Freedom Index + Macroeconomic Policies Index + Public Goods Index) – Socio-political Instability Index

2.3.2. Numerical confirmation of a global better public governance climate in South-East Asia compared to Sub-Saharan Africa

The data and methodology used in this paper confirm that the quality of the institutions in SEA is much higher than in SSA (table 1.3). SEA has fared better than SSA in terms of macroeconomic

5. Only the first principal component is used.

6. As institutions tend to be very stable over time, it would therefore be meaningless to observe the evolution of governance conditions over a short time period

Table 1.2

Description of the variables used to measure different governance dimensions

Variable	Description and explanation of choice	Source
Freedom		
Democracy	Democracy score.	Polity IV: *http://www.cidcm.umd.edu /inscr/polity/*
Contract Intensive Money (CIM)	Ratio of non-currency money to total money supply (M_2-Currency/ M_2). If citizens of a particular country believe that there is sufficient third-party enforcement, they are more likely to allow other parties to hold their money in exchange for some compensation, and CIM is correspondingly higher.	Clague *et al.* (1999) and data compiled by R. Bittick: *http://somc.csudh.edu/fa01_pub504/CIM%20data.xls*
Political constraint index	Measures the degree of constraints on policy change (checks and balances) with the assumption that on average, the benefits of constraints on executive discretion outweigh the costs of lost flexibility. This index can be seen as an indicator of credible political commitment.	Henisz (2000): *http://www-management.wharton.upenn.edu/henisz/POLCON/*
Political rights	Meaningful election of chief authority; meaningful election of legislature; fair campaigning; fair reflection of voter preferences; multiple political parties; no military control; decentralised political power; informal consensus; significant opposition vote; recent shift in power through elections; no denial of self-determination of major groups.	Freedom House: *http://www.freedomhouse.org*
Civil rights	No censorship; open public discussion; freedom of assembly; freedom of political organisation; guaranteed socio-economic rights; no gross inequality; no government indifference; no political terrorism; rule of law in political cases; freedom of religion; free trade unions; freedom of business; guaranteed personal rights; freedom of private organisations.	*Ibid.*
Public goods		
Number of telephone lines per 1000 people	According to Easterly and Levine (1997) and Collier and Gunning (1999), while telecommunications is the only widely available infrastructure variable, it is likely that different kinds of infrastructure are highly correlated.	*World Development Indicators (2000) CD-ROM*
Life expectancy at birth	Life expectancy at birth indicates the number of years a new-born infant would live if prevailing patterns of mortality at the time of its birth were to stay the same throughout its life. It can be seen as an indicator of the quality of the health system.	*Ibid.*
Gross secondary enrolment ratio	Ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of secondary education. Secondary education completes the provision of basic education that began at the primary level, and aims at laying the foundations for lifelong learning and human development. This ratio is therefore a measure of participation in education and should be correlated with the availability of skilled labour.	*Ibid.*

Macroeconomic policies		
Trade openness	Sum of exports and imports divided by GDP. A measure of trade liberalisation. Islam and Montenegro (2002) have shown that openness is positively associated with institutional quality : (1) international pressures and influences work to improve institutional quality; (2) openness tends to reduce rent-seeking and corruption behaviours due to higher competition; (3) better institutions are sought to manage the risk that comes from trading with unknown partners.	*Ibid.*
Export growth	Indicator of dynamic international competitiveness. For Berthélemy and Démurger (2000, pp. 149), "promotion of exports is likely to improve factor productivity through exploitation of economies of scale and improved use of production capacity".	*Ibid.*
Black market premium for foreign exchange	Parallel exchange rate/official exchange rate-1)*100. Indicator of the level of distortions in the economy, macroeconomic imbalances and corruption as exchange controls provide opportunities for corruption (Van Rijckeghem and Wedern 1997; Rodriguez and Rodrik, 1999). For Singapore, it has been assumed that the black market premium is null.	Compiled by the Global Development Network Growth Database (2002): *http://www.worldbank.org/research/growth/GDNdata.htm*
Total debt service	Debt service on long-term debt, short-term debt and repayments to the IMF as a percentage of exports of goods and services. Indicator of macroeconomic mismanagement and potential risk of capital flow restrictions.	World Development Indicators (2000) CD-ROM.

Socio-political instability		
Assassinations	The number of politically motivated murders or attempted murders of high government officials or politicians.	Arthur S. Banks Cross National Time-Series Data Archive (1999). Compiled by the Global Development Network Growth Database (2002).
General strikes	The number of strike of 1,000 or more industrial or service workers that involve more than one employer and that are aimed at national government policies or authority.	*Ibid.*
Guerrilla warfare	The number of armed activities, acts of sabotage, or bombings carried out by independent bands of citizens or irregular forces and aimed at the overthrow of the present regime.	*Ibid.*
Major government crises	The number of rapidly developing situations that threaten to bring the downfall of the present regime - excluding situations of revolt aimed at such overthrow.	*Ibid.*
Revolutions	The number of illegal or forced changes in the top governmental elite, any attempts at such change, or successful or unsuccessful armed rebellions whose aim is independence from the central government.	*Ibid.*
Civil war	An armed conflict is classified as a civil war if it satisfies the following criteria: (a) the war has caused more than one thousand battle deaths; (b) the war represented a challenge to the sovereignty of an internationally recognised State; (c) the war occurred within the recognised boundary of that State; (d) the war involved the State as one of the principal combatants; (e) the rebels were able to mount an organised military opposition to the State and to inflict significant casualties on the State.	Sambanis (2000): *http://econ.worldbank.org/files/13218_PartitionData.zip*

Table 1.3
Indicators of public governance dimensions for a pooled SEA and SSA sample

Index	Freedom		Public Goods	
Period	1976-85	1986-95	1976-85	1986-95
Country				
Benin	0.73	4.90	1.26	1.47
Botswana	9.42	**10.00**	2.41	3.26
Burundi	0.66	1.21	0.50	0.32
Cameroon	1.59	2.26	1.49	2.16
Central Africa	0.00	1.99	0.86	0.91
Chad	0.54	0.52	0.22	0.68
China	1.55	0.99	4.18	4.61
Congo	0.69	3.26	3.69	3.05
Côte d'Ivoire	1.84	2.07	1.39	1.57
Gabon	1.38	2.97	2.14	2.90
Gambia	6.97	6.37	0.43	1.55
Ghana	2.66	2.23	2.59	2.92
Indonesia	2.45	2.23	2.40	3.71
Kenya	2.89	2.45	1.95	2.30
Madagascar	1.92	4.70	1.93	1.65
Malawi	1.03	2.40	0.37	0.57
Malaysia	7.75	6.98	4.64	6.11
Mali	0.00	3.71	0.33	0.52
Mauritania	1.13	1.11	0.86	1.41
Mauritius	8.53	9.40	4.41	5.50
Niger	0.75	3.26	0.16	0.49
Nigeria	4.79	2.11	1.31	1.77
Philippines	2.99	8.13	4.37	5.19
Rwanda	1.32	1.48	0.49	0.11
Senegal	4.12	4.45	0.79	1.38
Sierra Leone	2.60	1.40	0.00	0.13
Singapore	3.58	4.15	7.56	9.99
South Korea	2.77	7.76	6.36	**10.00**
Thailand	5.88	7.75	3.20	4.14
Togo	0.90	2.25	1.74	1.68
Uganda	2.32	2.29	0.82	0.85
Zambia	2.36	4.29	1.45	1.58
Zimbabwe	4.68	3.11	2.05	3.15
SSA	2.53	3.32	1.37	1.69
SEA	3.85	5.43	4.67	6.25

Macroeconomic Policies		Socio-political instability		Global index of Public Governance		
1976-85	1986-95	1976-85	1986-95	1976-85	1986-95	Variation
5.17	4.30	0.00	0.56	7.16	10.11	41.20
6.64	5.59	0.00	0.00	18.47	18.85	2.06
3.88	2.89	0.17	2.83	4.87	1.59	-67.26
5.49	3.17	0.17	0.56	8.40	7.03	-16.26
4.48	4.83	1.58	0.37	3.76	7.36	96.07
5.17	4.96	4.46	5.17	1.47	0.99	-32.83
4.80	4.70	0.76	0.58	9.77	9.72	-0.56
5.16	3.74	0.76	0.50	8.78	9.55	8.71
3.90	3.25	0.00	0.37	7.13	6.52	-8.49
4.83	5.16	0.00	0.22	8.35	10.81	29.48
5.34	4.81	0.47	0.00	12.27	12.73	3.72
0.00	3.36	1.03	0.00	4.22	8.51	101.59
3.76	3.53	2.02	1.75	6.59	7.72	17.28
3.55	3.43	0.76	1.34	7.63	6.84	-10.39
2.97	3.09	0.17	1.77	6.65	7.67	15.36
3.51	3.27	0.00	0.00	4.91	6.24	27.09
5.49	6.43	1.61	1.16	16.27	18.36	12.82
5.10	4.56	0.52	1.44	4.91	7.35	49.80
4.53	3.51	1.55	0.00	4.97	6.03	21.23
5.28	5.96	0.16	0.37	18.06	20.49	13.45
3.35	3.36	0.35	0.63	3.91	6.48	65.68
3.63	3.86	2.10	1.77	7.63	5.97	-21.81
3.59	4.26	5.90	**10.00**	5.05	7.58	50.18
5.42	2.90	0.17	2.52	7.06	1.97	-72.11
4.45	4.03	0.00	0.00	9.36	9.86	5.34
2.35	4.21	0.31	1.46	4.64	4.28	-7.64
8.73	**10.00**	0.00	0.00	**19.87**	**24.14**	21.49
5.06	5.30	0.99	0.37	13.20	22.69	71.94
4.53	5.52	5.95	2.11	7.66	15.30	99.75
5.10	4.53	0.00	1.99	7.74	6.47	-16.44
1.82	1.38	4.23	2.62	0.73	1.90	159.67
3.11	1.81	0.17	0.22	6.75	7.46	10.62
4.02	3.82	4.76	0.00	5.99	10.08	68.35
4.16	3.84	0.92	1.03	7.15	7.81	9.33
5.14	5.68	2.46	2.28	11.20	15.07	34.58

policies, provision of public goods, political, civil and economic freedom. However, this region has also undergone higher socio-political instability, which has frequently been a prelude to democratic reforms. Conversely, political stability in Sub-Saharan Africa should be viewed by and large through the joint prisms of repression and immobility (Goldsmith, 1998).

While SEA countries are well-ranked, some SSA nations, such as Botswana, Mauritius and to a lesser extent Gambia or Benin, follow them closely. Moreover, SEA region hosts some « lame ducks », such as Indonesia or Philippines, which have not done much better, in terms of public governance, than the average African country.

Although no generalisation should be made without caution, globally, the public governance conditions of these two regions are opposite. This paper will now attempt to determine whether they have an influence on foreign direct investment flows and how well public governance explains the diverging attractiveness of SEA and SSA.

3. Econometric study on the impact of public governance on foreign direct investment in Sub-Saharan Africa and South-East Asia

It has been shown that, in theory, diverging governance conditions should explain why SEA has attracted much more FDI than SSA. For the sample used in this study, the difference in the weighted average share of FDI in GDP between SEA and SSA is 1.68%, over the 1976-1995 period (table 1.4 [7]).

7. Weighted averages, according to the share of the host country in regional output.

Table 1.4
Differences in the quality of the public governance between SEA and SSA

Index	*Freedom*		*Macroeconomic policies*		*Public goods*		*Socio-Political Instability*		*Global index of governance*			*Average share of FDI in GDP*		
Period	1976-85	1986-95	1976-85	1986-95	1976-85	1986-95	1976-85	1986-95	1976-85	1986-95	Variation(%)	1976-85	1986-95	Average
Zone														
SSA	3	3.08	3.89	3.69	1.53	1.99	1.16	1	7.26	7.77	7.02	0.98	0.67	0.825
SEA	2.97	4.47	4.82	5.11	4.65	6.33	1.95	1.28	10.49	14.63	39.57	1.76	3.25	2.505
Average differences between SSA and SEA	0,68		1,175		3,73		0,535		5,045			1,68		

Numerous studies have demonstrated that each dimension of public governance has a positive impact on FDI (table 1.5). In order to test whether the public indicators constructed in this paper help to explain the diverging abilities of SEA and SSA in terms of attracting FDI, a panel data model is used. The sample includes 33 countries in all - 26 SSA countries and 7 SEA countries (table 1.3). Two periods are observed: 1976-1985 and 1986-1995. As is standard in the literature, the dependent variable is the ratio of net FDI flows to GDP (Asiedu, 2002). The explanatory variables are the governance indicators, given in table 1.2 No other independent variables are included as the governance measures should proxy for most of the

determinants of FDI found significant in previous works (Wheeler and Mody, 1992; Singh and Jun, 1995; Chunlai, 1997). Nor is the output growth rate taken directly into account, since numerous studies have shown a clear link between economic growth and good public governance (Aaron, 1999 ; Dethier, 1999).

Concerning the estimated specification, the Breuch-Pagan lagrangian multiplier test suggests that the random effect model is more appropriate that a pooled model. Moreover, the Hausman test indicates that the former should be preferred to the fixed effects model. Accordingly, the equation to be estimated is :

$$(FDI/GDP)^{i}_{t} = \alpha^{i} + \beta(\text{Public Governance Indicator})^{i}_{t} + \varepsilon^{i}_{t}.$$

As illustrated by regression (1), the global public governance index is a strong determinant of FDI (table 1.6). This positive link appears to be driven by the macroeconomic policies index and the public goods index [(3,4,6,7)] ; other indicators are not significant [(2,5,6)]. These results are in line with other studies such as Wheeler and Mody (1992), Singh and Jun (1995), Chunlai (1997), Lehmann (1999), Asiedu (2001) or Carr *et al.* (2002) [7]. Thus, international investors, when they make their location decisions, seem to favour countries with (a) sustainable and outward-oriented market policies, and (b) a high provision of public goods. These factors of attractiveness have certainly mattered for different reasons in SSA and SEA. In Africa, during this period, most FDI inflows were resource-seeking and therefore raw materials had to be easily and cheaply exported; a high-quality infrastructure and an open trade

7. These results are robust to the inclusion of a dummy for exporters of natural resources (50 % or more of total exports).

Table 1.5
A selected survey of the impact of public governance on FDI

Impact of public governance on FDI	Impact	Authors
Freedom and political stability		
Social unrest and political uncertainty	-	Frey and Schneider (1985), Singh and Jun (1995), Lehmann (1999).
Democracy	+	Harms and Ursprung (2001) and Busse (2003).
Public goods		
Human capital and physical infrastructure	+	Wheeler and Mody (1992), Carr *et al*. (2002)
Bureaucratic corruption	-	Wei (2000), Wei and Wu (2001), Aizemann and Spiegel (2002),
Administrative procedures	-	Morriset and Neso (2002)
Macroeconomic policies		
Inflation, overvalued currency	-	Schneider and Frey (1985), Ahn *et al*. (1998)
Stable nominal/real exchange rate	+	Bénassy-Quéré *et al*. (1999), Aizenmann and Marion (2001).
Trade openness	+	Singh and Jun (1995), Chunlai (1997), Gastanaga *et al.* (1998), Lehmann (1999).
Property rights and contract enforcement		
Rule of law	+	Singh and Jun (1995), Lehmann (1999), Li and Resnick (2001) or Carr *et al*. (2002)
Intellectual property rights	+	Maskus (1998)
Corporate governance		
High governance standards	+	Survey of McKinsey (2002)

policy diminish transport costs. In Asia, FDI were more concentrated in the manufacturing sector. Owing to their openness, the low cost of a relatively skilled labour force and their proximity with Japan, these countries have indeed played an active part in the vertical integration of multinational enterprises [9].

On the other hand, the freedom index and the socio-political instability index are not significant. In SSA, it is likely that the return to investment was high enough to compensate for the lack of freedom and the political risk (Asiedu, 2002). Moreover, as argued by Busse (2003), « the firms in the extractive industries depended to a large extent on good relations with the government of the host country. To secure their investment and (later on) profits, the MNEs had to protect and keep access to the natural resource. In a similar fashion, host country governments depended in some cases on the flow of foreign exchange from the MNE investment in their country. Since both sides thus had an interest in physically protecting the investment, connections between MNEs and the host government could have been expected to be close and the MNEs might have supported repressive regimes ». In SEA, although authoritarian regimes were common at the end of the seventies, political leaders used as legitimising devices, « a commitment to sharing growth and the development of secure political foundation for granting economic rights to economic agents in the private sector » (Park, 2001, p.10). Furthermore, it is likely that multinational companies have viewed the political instability that has preceded the advent of democracy in certain SEA countries as temporary and not threatening for their investment.

9. In 1988, 52% of FDI stock in Africa was in the primary sector and 21% in the manufacturing sector. In Asia, the percentages were 14% and 43%, respectively (UNCTAD, 2001).

Based on regression (7) and table 1.4, it is possible to calculate the impact of diverging public governance conditions on the difference between FDI's average shares of GDP in SEA and SSA, over the 1976-1995 period (table 1.7). Thus, the quality of public governance accounts for 90% of this difference !

Table 1.6
Public Governance as a determinant of FDI in SEA and SSA

	Dependent variable: share of FDI into GDP in SEA and SSA						
Explanatory variables/Rregressions	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Constant	-.39	.90**	.15	-2.11***	1.32***	-1.83***	-1.98***
	(.42)	(.41)	(.35)	(.57)	(.33)	(.62)	(.56)
Global Index	.18***						
	(.04)						
Freedom Index		.08				-.04	
		(.09)				(.08)	
Public Goods Index			.44***			.24**	.21**
			(.10)			(0.11)	(0.10)
Macroeconomic Policies Index				.77***		.61***	.62***
				(.12)		(0.14)	(0.14)
Socio-political Instability Index					-.11	-.03	
					(.12)	(0.10)	
R?	0.32	0.05	0.28	0.45	0.01	0.49	0.49
Number of Observations	66	66	66	66	66	66	66
Number of countries	33	33	33	33	33	33	33
Hausman test (>chi2)	0.31	0.13	0.78	0.13	0.94	0.85	0.58

Standard deviations are in parenthesis and ***, **, and * denote significance at 0.01, 0.05 and 0.10 levels, respectively.

Table 1.7

Public governance as an explanation of the difference in FDI share between SEA and SSA

	Public Goods Index	*Macroeoconomic Policies Index*
Average differences between SEA and SSA	3.73	1.175
Coefficients given by (7)	.21	.62
Impact on average share of FDI/GDP	0.78	0.73
% of the difference in average FDI shares between SEA and SSA	Predicted difference by diverging governance conditions/ Real difference in average FDI share = (0.78+0.73) /1.68= **90%**	

4.Conclusion

By comparing Sub-Saharan African and South-East Asian host countries, this paper has demonstrated that public governance is a strong determinant of FDI inflows. First, various public governance indicators have been constructed which show that overall, SEA countries possess much better institutions that SSA countries. Second, it has been econometrically shown that FDI flows to countries that carry out sustainable and outward-oriented macroeconomic policies and deliver a high provision of public goods, such as a reliable physical infrastructure. The estimation results suggest that diverging public governance conditions account for 90% of the difference between FDI's average shares of GDP in SEA and SSA, over the 1976-1995 period.

The constructed indicators have been quite useful for several reasons. First of all, they offer a new analytical way of gathering and summarising usual and new determinants of foreign direct investment in the five dimensions of public governance. Next, they have been based on relatively quantitative and objective data, making them easily replicable. Finally, they are specific to the sample used, thereby allowing detailed comparisons between SSA and SEA countries. They are a huge improvement on country-risk commercial indicators, which tend to be too subjective, unclear from a methodological point of view, do not rate all countries and give broad scores which are not always sufficiently dispersed to distinguish the business climate of two different countries.

To sum up, this paper suggests that countries wishing to attract these capital flows and benefit from their alleged positive effects in terms of productivity and growth [10], must earmark a larger share of their resources to strengthening their institutions.

10. Surveys on the impact of FDI on the host country economy can be found for instance in Hanson (2000) or Lipsey (2002). On the basis of case studies, Moran (1998) also suggests that the magnitude of the spillovers depends on the host investment climate.

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Chapter 2.
Do Export Processing Zones Make Sense as Means to Achieve Development ?

Edward M. Graham [11]
Institute for International Economics

During the past several years, governments of a number of countries, among them certain quite large ones (India, Russia), have expressed interest in developing export processing zones on their territories. Most such countries are ones that would like to attract more foreign direct investment into their economies but, for one reason or another, have been reluctant fully to liberalise trade policy or policy towards foreign investors or, indeed in some cases, have remained essentially non-market economies. The basic idea of an export processing zone (EPZ) is that, inside the zone, enterprises (which are usually foreign-controlled although not strictly necessarily so) produce products, including services, for export but not for local consumption largely free of regulation by local governments. Thus, for example, these enterprises might be exempted from restrictions placed elsewhere on the economy on imports and, in

11. This paper is based partly on Graham (2004). I would like to thank Professor Xiaming Liu for comments on an earlier draft of this paper that were most useful.

addition, might be at least partly exempted from local labour laws or regulations. Because of the latter, the very concept of an EPZ has generated hostility on the part of labour unions and socially-oriented non-governmental organisations worldwide, especially ones located in the OECD nations.

Moreover, development institutions such as the World Bank have often been less than enthusiastic about EPZs. (For a view of EPZs from within the World Bank, see Madani 1998). Reasons for this lack of enthusiasm include all of the following :

1. Because EPZs are deliberately isolated from the domestic economy of a nation, the opportunities to capture many of the benefits from foreign trade or foreign direct investment (FDI), *e.g.*, « spillovers » (positive externalities), are lost or greatly reduced.[12]
2. A related mater, and also because of their isolation from the domestic economy, EPZs create few or no opportunities for linkages between foreign investors and local supplier firms, where these linkages could increase significantly the opportunities and capabilities of the latter.
3. Few or no benefits potentially created by competition between foreign-controlled and locally-controlled enterprises are likely to materialise in EPZs.

12.The issue of whether or not foreign direct investment (FDI) in general creates spillovers has created quite a large empirical literature, where the conclusions of various studies are not consistent. Some studies show spillovers and others do not. For a review of recent empirical studies, see Görg and Strobl (2001). A number of studies have shown lack of spillovers specifically from FDI located in economic processing zones (Rhee, Katterbach, and White 1990), and this seems to be true for China as well as for other countries (Wei 1996, Lemoine and Ünal-Kesenci 2004, *op. cit.)*. However, there does seem to be some association between FDI in China and acceleration in total factor productivity growth (Dayal-Gulati and Hussain 2000, Graham and Wada 2001 *op. cit.*). This does not necessarily suggest that there are spillovers, as the productivity gains might be wholly internal to foreign-invested enterprises, but it does suggest some technology transfer to the economy as a whole.

4. Because enterprises created through foreign direct investment or domestic investment in these zones operate under relatively privileged conditions, and because permission to invest in the zone typically must be obtained from government officials (because entry into the zones is regulated by the government), opportunities for corruption can be created.

Against these reasons, proponents of EPZs argue the following lines :

1. EPZs can enable capture of at least some benefits, even if not all potential such benefits, of increased FDI and trade in countries where political barriers prevent full liberalisation of trade and foreign investment policy.
2. If successful in creating this capture, the EPZs might create a demonstration effect that leads to more general liberalisation.

As evidence of the validity of these two arguments for EPZs, proponents point to the experience of China where, during the 1980s, a number of what would effectively become EPZs were established. These in fact do seem to have created some benefits that were captured by the local economy. Moreover, Chinese experience was that success with the EPZs (or, as they were termed, Special Economic Zones or SEZs [13]) indeed did motivate more general economy-wide policy reform. In particular, on his now-famous (or famous at least within China) trip to

13. These zones were designated as " Special Economic Zones " because they were designed to do more than serve as export processing zones (Ge 1999, Wu 1999, and Graham 2004 *op. cit.*). In particular, they were meant to serve as laboratories for economic reform (see below) and also as vehicles for technology transfer into China. On the lattermost matter, activities established in these zones seem to have failed to have achieved a great deal of technology transfer (Lemoine and Ünal-Kesenci 2004). However, a major priority was to generate export activity (Jia 1994) and in this matter, as shall be argued, the zones did succeed. Thus, although these zones were meant to be more than just export processing zones, they in fact evolved to become largely generators of exports, and they are thus treated in this paper as being primarily EPZs.

the south of China, Chinese President Deng Xiao-peng observed first-hand the employment and export activity that was being generated in the SEZs and in other zones that followed the initial establishment of the SEZs (see below). Why not, Deng asked rhetorically, end the restrictions on foreign direct investment so that the same activity would be generated elsewhere ? The rhetorical question was followed by a series of liberalising measures in 1991 whereby many restrictions on foreign investment, and particularly that foreign investment meant to generate exports, were ended.

In the years following these reforms, foreign direct investment in China positively boomed, such that by 1995 China was the largest recipient of greenfields FDI in the world and in 2001 China became the largest net recipient of all types of FDI. This FDI has played a major role in the truly impressive growth of China since the early 1990s (for a general account, see Lardy, 2002). In particular, foreign-invested enterprises in China have accounted for the majority of export growth that has been a major factor fueling this growth (Table 2.1 ; and also see Lemoine, 2000 ; Graham and Wada, 2001, and additional references contained in these.)

I have argued in detail elsewhere (Graham 2004, *op. cit.*) that the SEZs in China thus should be counted as a major success. One reason of course is that they indeed did deliver benefits, notably generation of new exports and employment, to China during the 1980s. In fact, however, these benefits during the 1980s were rather modest when compared with those that accrued during the 1990s. But, given that the performance of China in terms of employment and export creation during the 1970s was quite dismal, the improved performance of the 1980s looked quite good by the end of that decade. Much

Table 2.1

Share of Foreign Invested Enterprises (FIE's) in China's Foreign Trade 1986-2002 (US$ billion)

Year	Total trade			Net Exports by Foreign Invested Enterprises		
	Total Trade	FIEs	%	Exports	Imports	Net
1986	73.85	2.99	4.04	0.58	2.40	-1.82
1987	82.65	4.58	5.55	1.21	3.37	-2.16
1988	102.78	8.34	8.12	2.46	5.88	-34.2
1989	111.68	13.71	12.28	4.91	8.00	-3.88
1990	115.44	20.12	17.43	7.81	12.30	-4.49
1991	135.70	28.96	21.34	12.05	16.91	-4.86
1992	165.53	43.75	26.43	17.36	26.39	-9.03
1993	195.70	67.07	34.27	25.24	41.83	-16.60
1994	236.62	87.65	37.04	34.71	52.93	-18.22
1995	280.85	109.82	39.10	46.88	62.94	-16.07
1996	289.90	137.11	47.29	61.51	75.60	-14.10
1997	325.06	152.62	46.95	74.90	77.72	-2.82
1998	323.92	157.68	48.68	80.96	76.72	4.25
1999	360.65	183.13	50.78	88.63	85.88	2.74
2000	474.28	236.67	49.91	11.94	11.73	0.22
2001	509.77	259.10	50.80	133.24	125.86	7.37
2002	620.79	330.22	53.19	169.94	160.27	9.65

Sources: Adapted from comment on this paper by Professor Xiaming Liu. Data for 1986-2002 from Website of the Ministry of Commerce of the People's Republic of China – www.mofcom.gov.cn/tizl.shtml.

more importantly and as noted just above, the modest success of the SEZs motivated further and deeper reform in China. It is this reform that has put this ancient but, as of 1990, still rather economically backward nation onto a very rapid path of economic growth during the decade of the 1990s and continuing to the present time. It is quite arguable that, had this deeper reform not occurred and the ensuing growth not happened, the SEZs would not today be seen as nearly as great a success as they indeed now are seen. But it is also arguable that, without the SEZs, the deeper reform would not have occurred.

Skeptics of EPZs might nonetheless argue that the conditions for the success of the SEZs in China were *sui generis* to this very unique country, such that the success is unlikely to be repeated elsewhere. This is a very fair point, and hence it is worthwhile to examine some of the underlying conditions that led to the creation of the SEZs in China.

To begin, the SEZs were the outcome of laws passed in 1978 and 1979. (For details of these laws, see Jia, 1994). The first of these opened the door, but only a little, to FDI in China where previously the door had been almost entirely closed. The second law enabled the creation of zones where foreign and domestic investors could operate export-generating activities free from most of the regulation then present in China. Both laws were passed at a time when China was still reeling from the ravages of the « Cultural Revolution » of the late 1960s and early 1970s that had created both major social unrest and significant setback of the Chinese economy. Moreover, there were protracted power struggles within the Chinese leadership following the death of Mao Zedong in 1975, and just exactly who was in charge of the nation was not fully settled even in 1978.

Furthermore, the Cultural Revolution had left in its wake significant albeit disguised unemployment in China. The threat of escalating social instability was very real, and Chinese leaders of all stripes were well aware that China's history showed that civil war and popular revolt were never to be dismissed. Indeed, the Communist Party had come into power in 1949 as the result of a protracted civil war.

Against this background, there emerged two clear factions in the Chinese leadership, albeit that not all members of the leadership necessarily identified themselves with either of the factions. One of these, which I will term the « hard-liners », held that the Communist structure of China, meaning state ownership of all economic assets of significance and centralised control and supervision of the economy, should be preserved. This faction has also been called the « Beijing Clique » or the « Li Peng Faction ». The other faction, which I will term the « reformers », believed that China should move towards a more competition and market-driven economy, albeit one in which state-owned enterprises would remain active. This faction has also been called the « Shanghai Clique » or the « Deng Xiaoping Faction » ; I use the term « reformers » because « reform » has come to denote, in socialist and formerly socialist nations, policy change meant to create a more market-driven economy. Both factions believed that the Communist Party should remain as the only political organ in the country and that the top members of the Party would continue to be the top-level governing officials of the nation.

Although the positions of the hard-liners and the reformers with respect to the future of the Chinese economy differed substantially, in the late 1970s both factions did see utility in setting up special economic zones in which foreign-invested enterprises would be created.

For the hard-liners, this followed from recognition that the economic situation was dire enough that steps needed to be taken to improve the economic performance of the nation if escalating social unrest was to be avoided. Almost surely, the hard-liners saw these zones as a way to improve economic performance but, at the same time, to put limits on the amount of reform that would be implemented in China.

The reformers, by contrast, saw the special economic zones as « laboratory experiments » with reform whereby it could be tested whether reform would actually bring benefits to the Chinese economy. Moreover, because there were to be created more than such zone, a number of different experiments could be run simultaneously. Indeed, the reformers almost surely, and in contrast to the hard-liners, believed that extensive reform of the Chinese economy was necessary and that the zones would be used not only to demonstrate the effectiveness of reform but as means to fine-tune the reform. Experiments in the zones that proved effective might then be implemented nation-wide while experiments that fizzled would be discarded. As noted, in 1991, much of the policy of openness that had been tried experimentally in the zones indeed was extended to the whole of the Chinese economy.

The laws enabling greater FDI and the creation of SEZs thus were supported by both factions of the divided leadership. Moreover, both factions were more pragmatic and less ideological than might have been expected. Thus, when the SEZs proved to work as the reformers hoped, the hard-liners were prepared to make further concessions than they had originally been willing to make. But, presumably, had the SEZs not delivered the promised benefits, the reformers might have been prepared to abandon unsuccessful

reforms, albeit we cannot say this with as full assurance. The fact was that most reforms tried in the SEZs did prove to be quite successful and, thus, we can never know if the reformers would have given up on reform had this not been so. But one consequence of pragmatism has been that, although the balance of power in China seems to have tipped towards the reform faction, and especially so since the Tiananmen Square incident of 1989 that has largely been blamed on the hard-liners, both factions still coexist within the Chinese leadership even now. Thus, if the balance of power does indeed favour the reformers, this is so in large measure because the hard-liners eventually accepted that reform, by and large, has worked in China.

Pragmatism thus characterised the implementation of the SEZs. Initially, in 1981, four of these were opened, in coastal cities of China judged to be those where foreign investors might prefer to locate their operations. This is in sharp contrast to the approach taken by many other countries where EPZs have been located in depressed regions unlikely to be ones where foreign investors would choose to locate operations in the absence of major incentives to do so. Moreover, in the spirit of experimentation, local officials in the cities and provinces in China where the SEZs were located were given a great deal of autonomy in how the zones were run and even in how to interpret the laws governing the operation of the zones. Given that there were multiple zones, each operating with much autonomy, there developed competition among the zones such that each zone tried to match or better other zones in terms of its attractiveness to foreign investors. As one consequence, the degree of liberalisation that actually took place within the zones often exceeded that which was specified by law (Lardy, 1994). Perhaps more

important, the competition among zones to attract foreign investment almost surely limited the amount of corruption that might have been generated by these zones. After all, a foreign investor was not likely to pay a bribe to local officials in one city to gain entry to one particular when another zone within the same region of China sought the same investor but on better terms.

Even so, foreign investment in the zones built up rather slowly at first. Disappointed with this result, the top leadership amended the 1978 law to drop requirements that operations in China be formed as joint ventures with Chinese enterprises (at that time, Chinese enterprises were almost entirely state-owned) and that the heads of these joint ventures be Chinese nationals (Jia, 1994). Over the next couple of years, foreign direct investment flow into China tripled.

Even in spite of the rather slow accumulation of FDI, local officials in those areas where the zones existed were delighted with early experience of the SEZs. Indeed, the experience was perceived as so positive that local officials of those cities where no SEZ had been approved soon put pressure on the central government to have created more zones so that their cities might have one also. Thus, in 1984, fourteen additional coastal cities were designated as « Economic and Technical Development Zones» . As such, these cities were allowed to offer exporters almost all of the same privileges that were offered by the SEZs and, in allowing these new zones to be created, the Chinese leadership expanded the scope of the experiment with reform. Furthermore, seeking to create their own SEZs, a number of cities where no SEZ or EPZ was designated, did so without central government permission. Thus, when in 1988 a fifth formally designated SEZ was created on Hainan Island, the number of *de*

facto export processing zones that were operating in coastal areas of China probably exceeded 100 (Rosen, 1999).

Again, it is to be stressed that most of these zones were operating in areas of China that were advantaged from the point of view of attracting foreign investment. These areas had, by the standards of China at the time, well developed physical infrastructure and, probably more importantly, well-developed human capital. Almost all persons in coastal China at that time were literate, and a disproportionately high percentage of the nation's university graduates were located there (Jia, 1994).

As noted earlier in this paper, some but not all of the benefits of the SEZs that had been originally sought during the late 1970s were being realised by the late 1980s. This was especially so with respect to generation of employment and exports. Exports had been sought because, in the late 1970s, availability of foreign exchange was a significant constraint on Chinese growth due to difficulties in financing imports of needed capital goods. Again, though, not all of the potential benefits of foreign direct investment were being realised. Even following the nation-wide reforms of 1991, for example, formal linkages between foreign-invested enterprises and domestic firms remained scant, limiting the amount of inward technology transfer. Such benefits in fact never seem to have been realised in export-generating foreign-invested enterprises, or at least not at levels hoped for by the economic reformers (Lemoine and Ünal-Kesenci, 2004).

However, beginning in the second half of the 1990s, foreign direct investment in China has begun to move away from labour-intensive, export-oriented activities towards more technologically sophisticated ones more oriented to servicing the local Chinese

market. One consequence might be increased spillover from this investment, although it is probably too early to measure whether this is indeed occurring. On the changes in the type of FDI entering China's Guandong Province, see Zhang and Kang (1997). The shift in technological sophistication of investment might be driven at least in part by changes in Chinese policy implemented in the late 1990s to remove restrictions and conditions on FDI that likely hindered technology transfer; see Long (2001). One consequence might be a greater amount of spillover in the future than has been evident during the 1990s.

We must now address the central question of whether the creation of EPZs makes sense in developing countries other than China in light of the Chinese experience. On this, to begin, let us remind ourselves that creation of such zones in China was supported by two major factions within the nation's leadership, one that wanted to experiment with reform and another that almost surely wanted to minimise reform. In this matter, China is almost surely not the only nation in which national leadership is split over whether, or how fast, to implement reform. India, for example, exhibits a similar split. The prime minister of India, Manmohan Singh of the Congress Party, who at the time of this writing has been in office less than four months, is an ardent reformer. Indeed, as Finance Minister during the early 1990s, he oversaw the first major period of reform in India's post-independence history, and the process of reform continued after Congress lost power in 1996. But he is opposed on this matter by numerous constituencies in India, including ones within his own Congress Party. As just noted, India has undergone a period of more than ten years during which reforms have been implemen-

ted, but India's policies towards foreign direct investment are, even so, arguably less liberal than those of China. Given this, the creation of EPZs in India might indeed be a reasonable way in which to experiment with deeper reform, especially as regards foreign investment.

This is not meant to judge, or even predict, what course India will take with respect to EPZs. Rather, it is only meant to suggest that the policy environment in which such zones might have a chance to work as they did in China might be in place in India. This might, alas, not be the case for many other nations. Here are some general situations, with specific examples where possible, where my best guess is that EPZs might not produce significant benefits and where, thus, I would have to agree with what I characterised as the « World Bank » view at the beginning of this paper :

A. *In countries where there is no constituency or faction within the national leadership in favour of reform.* In such countries, EPZs are usually seen as a means to capture benefit from foreign direct investment without the country having to undergo significant internal reform to create an environment in which foreign-controlled enterprises can flourish. In other words, EPZs are, in these countries, often seen as a way to « achieve something for nothing ». This approach is almost surely doomed to failure. For example, as something of an extreme case, North Korea has tried to set up special economic zones modeled (somewhat) on the Chinese zones, but with no real success to date. One reason for lack of success is simply that there is no commitment to reform, nor apparently any faction in favour of reform, within the North Korean leadership. As stressed, this was not the case in China.

B. *Where an EPZ is meant to foster development in a region of a country that is extremely disadvantaged.* As noted above, this was not the Chinese model. Rather, in China, the SEZs were deliberately placed in that region of the country – the coastal region – where authorities correctly judged that foreign investors would be most inclined to locate their operations. Subsequently, as this region indeed began to draw very large amounts of FDI, Chinese persons from less advantaged regions began to migrate into the advantaged region. The wisdom to be drawn from the Chinese experience is simply this: If a country is contemplating EPZs to begin, this is a signal that the whole country is disadvantaged from the perspective of foreign investors as a location for their operations. The EPZ is meant to offset whatever factors create this disadvantage. It makes no sense then to burden the EPZ with further sources of disadvantage. A specific example can be cited: Pakistan now seeks to create an EPZ in a depressed region of the country. Again, I don't seek to prejudge any country's action; but nonetheless, my guess is that, given the disadvantaged location of the zone and factors cited in the next item below, this will not prove a success.

C. *Where only a single EPZ has been established in a country.* As noted at the beginning of this article, the World Bank cites the potential for corruption as a reason why EPZs might not be a good idea. The experience of China indicates, logically enough, that this problem can be avoided (albeit almost surely never entirely eliminated) if multiple zones are established and allowed to compete with one another to attract

foreign investment. This is not to say that there is no corruption in China. What there is to say thus is that, if zones do vigorously compete with one another, the Chinese experience shows that corruption can be contained at levels that do not create total dysfunction.

On this last point, I am somewhat loath to cite specific examples. Let me note instead that, in my years as an economist, I have visited more than one export processing zone, located on more than one continent, that clearly has been quite dysfunctional. While there often are multiple reasons why these zones are dysfunctional, local persons with some knowledge of the operations of the zones have suggested that corruption at many levels has been a big factor. The wonder then of the SEZs and SEZ-like zones in China is that corruption did not render the zones dysfunctional. I would judge that the main reason why the zones worked in China (and indeed continue to work) is simply that, as noted above, if the officials in Guangdong Province ask for too many « side payments » as a condition for investing there, a foreign investor can simply locate in Fujien Province or any of six other areas where foreign investment has been able to thrive.

This suggests then that a necessary condition for making EPZs work in a country is that there be more than one such zone and that the zones compete with one another. While this might not be a sufficient condition for the zones to be successful, it seems that without such competition, the prospects that the zone creates the sought-after benefits are scant.

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Comments

by Françoise Lemoine
CEPII

The paper raises an interesting and crucial question about China's opening-up policy: Have the Special Export Zones (SEZs) been successful? Were they a necessary stage which has paved the way for the far-reaching liberalisation China implemented in the 90s ?

I agree with the conclusion of the paper, which argues that SEZs have been a success. The following points are worth stressing :

First, the author is right to put the creation and the performance of SEZs in their context, *i.e.* the very initial phase of China's opening-up. Now that huge amounts of FDI are flowing to China, it is easy to forget that in the early 80s, China was an almost completely closed economy, there was no consensus within the leadership about the strategy of reforms, and foreign companies naturally viewed investing in China as risky. SEZs were a laboratory for both Chinese and foreign partners to experiment a completely new type of relationship.

Second, FDI to China reached a significant level in the second half of the 1980s, as it amounted to some of 2% of FDI worldwide and 10% of FDI to LDCs. These flows may look small only in the light of their tremendous increase in the 1990s.

Third, the fact that the authorities had to increase the number of open zones in 1984 under the pressure of provincial authorities seeking to benefit from foreign capital shows that the emulation

effect was strong. The measures taken in 1991 to liberalise FDI and extend incentives to the whole coastal area confirm the positive assessment of the policy implemented in the SEZs.

Fourth, the initial concentration of FDI in Guangdong has had lasting effects on the provincial distribution of FDI. It must be underlined that FDI in Guangdong which was initially located in Shenzhen, has tended to flow outside this SEZ to the Pearl river delta, where labour costs are lower. The concentration in Guangdong province has favoured the development of clusters of activities, which have been instrumental in the development of export capacities in such sectors as electrical and electronic goods.

I think the paper might have provided some figures to support the argument that SEZ have played a decisive role in boosting China's manufacturing exports. For instance, in 2003, the four initial SEZs accounted for 10% of China's exports, as against 14% for the other zones opened.

I shall now take up another point which is addressed in the paper and which concerns the linkages between foreign affiliates and the domestic economy and to technology transfer.

The goal of the Chinese leadership in setting SEZs was to attract FDI in export-oriented industries while avoiding overly strong competition for domestic firms. Given the context and the goal, the SEZs have been a success. The question is whether this policy, once it was extended to the country as a whole in the 1990s, has not led to some unexpected and sometimes undesirable results.

First, the argument that the preferential treatment applied to foreign affiliates (tax rebates or exemptions) may have put domestic firms at a disadvantage is quite convincing. This may

explain the key part that affiliates of foreign firms play in China's industry (one-fourth of industrial production and much more in some sectors).

Second, the policy of encouraging outward-oriented industries has perhaps succeeded beyond the expectations of Chinese policy-makers. Exempting from custom duties the intermediate goods imported to be transformed or assembled for exports has tremendously boosted international processing in China, which has become an assembly country. Most of the increase in China's exports is due to these international processing activities, the bulk of which is handled by foreign affiliates.

This has several major consequences :

1) Processing activities have not favoured forward and backward linkages between foreign affiliates and Chinese firms; moreover, custom exemptions may have fostered imports of intermediate goods at the expense of local supplies.
2) The dominant role of foreign affiliates in China's trade also means that they handle most of China's imports (and exports) of high-technology products, which casts some doubts on the dissemination of foreign technology to the domestic (Chinese) industrial firms.
3) This policy seems to have reinforced the dualism of China's industry. In the export sector, it has led to the development of highly internationalised and competitive industries, dominated by foreign firms, while traditional exports, dominated by Chinese firms, have lagged behind.
4) It is to be expected that trade and investment liberalisation associated with China's accession to WTO will tend to

alleviate this dualism. It will level the playing field between foreign and domestic firms (as customs duties are lowered, the impact of exemptions will be reduced).

My conclusion would thus be that SEZs have been a success, but when this experiment was extended to the country as a whole, it gave rise to distortions in China's foreign trade activities.

Chapter 3.
Red Carpets and Red Tape : *Institutions and the Geography of FDI in Vietnam*

Klaus E. Meyer [14] and Hung Vo Nguyen

1. Introduction

A market-based institutional framework is essential for attracting FDI to a country (World Bank, 2002). Yet foreign investors consider more then the formal national institutions when deciding how and where to set-up their operations. In addition, foreign investors are concerned with local institutions, and with informal, often less evident aspects of the institutional framework. These institutions co-evolve in complex interactions between formal and informal institutions (North, 1990) at national as well as local level. Moreover, institutions co-evolve with organisations as an institutio-

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nal set-up favours the development of certain types of organisations, and organisations support the institutions they have come to rely on (Lewin *et al.*, 1998 ; Hall and Soskice, 2001).

The interaction between national and local institutions may well result in a situation where a favourably minded national government is rolling out a '*red carpet*' for foreign investors, while bureaucratic minded local governments create '*red tape*'. Or an entrepreneurial local authority rolls out the red carpet, and thus moderates the deterring effect of *red tape* created by a bureaucracy in the central government. Developing countries that are large and administratively decentralised thus have to manage this dual tension between national and local institutions, as well as between formal and informal institutions.

The complexity of co-evolution of institutions, and their impact on FDI, can be observed in Vietnam. Formally, Vietnam has been a socialist republic with state-ownership central planning for more then a decade before embarking on reform in the late 1980's (and even longer in the North). However, traditional value systems and entrepreneurial spirits survived in the informal sector. Economic reform was initiated in 1986 with many small changes in the formal institutions at national level. Yet the implementation of reform, and the development of market-oriented institutions, depends very much on initiatives taken by local authorities and organisations. In consequence the institutional framework faced by business varies within Vietnam, especially with respect to informal aspects.

Foreign investors take this institutional variation into account when making their investment decisions. Thus, we observe that FDI in Vietnam is concentrated in the traditional economic hubs,

Hanoi and Ho Chi Minh City (HCMC), as well as a small number of other provinces that made deliberate attempts at creating a business friendly institutional environment (Meyer and Nguyen, 2004).

This chapter explores the relationship between the pattern of FDI and institutions at local level. In the next section, we set the stage by reviewing the economic geography literature on FDI. In section 3, we present an institutional perspective on foreign investment strategies and develop our own theoretical framework. This framework is in section 4 applied to interpret the institutional change processes currently under way in Vietnam. In section 5 we present empirical evidence in form of patterns of FDI, and we summarise an empirical study showing the impact of local institutions on FDI. This quantitative evidence is then further elaborated by drawing on interviews that we conducted in a particular successful province, and with foreign investors operating nation wide. Section 6 concludes with policy implications for large and administratively decentralised emerging economies. Handing over responsibilities to local authorities opens opportunities for entrepreneurial initiatives, but it may also increase risks and transaction costs.

2. Economic Reform in Vietnam

Vietnam started a gradual path of reform in 1986 following the Chinese example of gradualism. However, the communist party remains firmly in power, and many aspects of the economy are subject to regulation or direct interference by the government or the party. The legal framework for FDI has evolved with major and minor changes throughout the 1990's, after the first FDI law has been passed in 1987. Yet other legal and administrative changes have

been equally important for foreign investors, including the rules and procedures concerning investment licenses, land lease, recruitment and salaries, investment guarantees, and taxation (Gates, 2000 ; van Arkadie and Mallon, 2003 ; Nguyen *et al.*, 2004).

However, compared to neighbouring countries, « many areas, such as retail trade, goods distribution service, finance, insurance, and real estate business are still very restricted to foreign investors … while … lists [of industries open or closed to FDI] are general and unclear, leading to difficulties in practical implementation » (CIEM, 1999). Moreover, 100% foreign ownership is not permitted in a wide range of industries, and Vietnam lacks a one-stop agency supporting potential investors in implementing their projects (CIEM, 1999). Private ownership of land by foreigners is also limited, which make land-use-rights a key contribution of local partners to joint ventures in Vietnam.

The reforms have decentralised some policy responsibilities, delegated some budgetary responsibilities to provinces and gave them some autonomy with respect to the FDI policies. Decentralisation was stipulated in the foreign investment law in 1996 and came into effect in 1997. It has given provincial authorities an active role in dealing with FDI. For the first time, local authorities have gained responsibilities to grant investment licenses for FDI projects at scale of up to US$ 5 million (US$ 10m for Hanoi and HCMC) that not belong to a sensitive or regulated sector. For larger FDI projects, provincial authorities are responsible to support foreign investors in the preparation of the documentations to apply for investment licenses at a higher level of authorities (Nguyen *et al.* 2004). Moreover, since 1997, many regulatory and supervisory functions related to FDI have been delegated, for instance land lease rate (within the centrally

mandated range), import & export licenses, labour recruitment etc. This allowed provincial authorities to develop innovative ways of dealing with foreign investors. Yet, their newly gained authority is used quite differently, not only between the urban centres and rural areas, but also between the North and the South.

The pattern of business organisations varies from other countries, and reflects the path of reform over the past decade. State-owned firms still generate more output than the domestic private sector, but their share has fallen below 40% by the turn of the millennium (Nguyen *et al.*, 2004). A restructuring program for state-owned firms, supported by multilateral institutions such as the World Bank, envisages « equitisation » (a synonym for privatisation), reduction of subsidies, and restructuring of non-performing loans. Vietnam's state-owned firms thus gradually have to face more market-oriented performance criteria, yet, for the time being, they remain major economic and political agents both at the national and the local level (van Arkadie and Mallon, 2003).

The private sector had historically been restricted and was subject to substantial discretionary interference by governmental authorities. Only in 1999, policy changed towards supporting the establishment and operation of private enterprises, leading to a surge in registration with 56,000 new enterprises and registered capital of US$ 6.7 billion in 2000 to 2002 (compared to 45,000 new enterprises in 1991 to 1999). Yet since most of these private businesses are still small, they have little political influence on the national stage, despite their increasing economic importance (Tenev *et al.*, 2003).

Foreign investment was first permitted in 1987, and over the next years FDI regulations were gradually liberalised. Annual FDI

capital inflows increased to over US$ 2 billion by 1995, when it stabilised at that level before falling in the late 1990's. Rather then these absolute numbers, the relative importance of FDI for Vietnamese GDP and international trade are remarkable. In 2002, FDI accounted for 35% of industrial output, 34% of imports, and 47% of exports (Statistics Publishing House, 2004a). By July 2002, FDI enterprises employed 596,016 persons, which corresponds to 15.5% of employment in enterprises (Statistics Publishing House, 2004b).

3. The Economic Geography of FDI

The location of production is first and foremost a function of the costs and quality of local factors of production, *i.e.* comparative advantages of resource endowments. Labour costs and productivity are a prime concern for many industries that manufacture in emerging markets for export, for instance for textiles or electronics. Efficiency- or resource seeking investors would consider the costs and quality of those local resources that they require for their operations, including natural assets, like the local workforce and natural resources, and increasingly "created assets" such as human capital and infrastructure (Narula and Dunning, 2000). These factor costs have to be balanced with the costs of bringing goods to market, which depend among other influences on the traffic infrastructure, distance to markets, and trade barriers in key export markets. Empirical studies confirm that FDI follows factor endowments, for example in China (Head and Ries, 1996 ; Cheng and Kwan, 2000).

Secondly foreign investors set up production near their markets. The attraction of markets is first and foremost a function of

their size, their expected growth and their sophistication. The location of market-seeking investment aims to obtain market access, often by establishing operations in the main commercial hub of the host economy (especially for consumer goods), or in close proximity to key customers (when selling B2B goods). The empirical relationship between FDI and the GDP level and growth of host economies supports this line of argument.

A different theoretical foundation to explain the location of FDI is economic agglomeration. This literature stipulates that firms benefit from locating in the vicinity of other firms in the same industry, *i.e*. in a cluster. They benefit from specialised labour markets, the availability of suppliers to the industry, and the exchange of knowledge with other firms in the cluster. Moreover, new investors may use the experiences and performance of earlier investors as indicators of the underlying business climate at the location. Thus strong forces lead to a centralisation of economic activity, while countervailing effects of, for instance, real estate costs favour decentralisation. With respect to the location of FDI, the economic agglomeration literature suggest the following effects :

- FDI locate where other firms in the same industry are already established.
- FDI locate where other FDI firms are already established.
- FDI locate where other FDI firms from the same country of origin are already established.

Empirical evidence supports all three propositions. The second proposition has been demonstrated empirically showing that new FDI locates where there is already a large stock of FDI (Cheng and Kwan, 2000; Head and Ries, 1996), and including the stock of FDI

at any given location in as an independent variable. Agglomeration effects have been shown specific to FDI from the same country origin, in the USA for Japanese investors (Head *et al.*, 1999), and in China for Taiwanese and Hong Kong investors (He, 2003).

The fourth theoretical foundation is the institutional perspective, which is the focus of this chapter. FDI research has considered institutions when analysing FDI flows between countries. This literature points out that investment incentives, tax rates and absence of performance requirements encourages FDI (Loree and Guisinger, 1995) and, more generally, market-oriented institutions and a private property rights regime attracts more foreign investment (Globerman and Shapiro, 2003). Empirical research in emerging economies finds major institutional influences of the strategies of both domestic firms (Peng, 2000 ; Khanna and Palepu, 2000) and foreign direct investors (Meyer, 2001 ; Bevan *et al.*, 2003).

Yet there is little research on institutions and FDI at sub-national level. Some studies consider formal institutions, especially taxation policy in the case of the USA, and the existence of special economic zones in the case of China. In the USA, Coughlin *et al.* (1991) find that higher taxes deterred FDI, while promotional activities and transportation infrastructure increased FDI. Hines (1996) finds that state corporate taxation lowered FDI from those countries of origin where investors are not taxed for foreign profits; while there was no effect on FDI from Japan and the United Kingdom, where foreign profits are taxed yet credits are provided for tax paid in the USA. Head *et al.* (1999) find that states' tax policy, and the existence of a free trade zone attract FDI, while the existence of a promotional office is insignificant. In China, the incidence of

special economic zones has been introduced as a policy factor as a dummy variable (Head and Ries, 1996).

However, a broader setting of influence FDI strategies in emerging markets. We find that, in addition, the size of industrial parks in terms of real estate is important for FDI, as is the ownership structure of the local industry (Meyer and Nguyen, 2004). These influences are part of a complex interaction between institutions, institutional change and FDI, that we explore in the next section.

4. Institutions and FDI

4.1. A Conceptual Framework

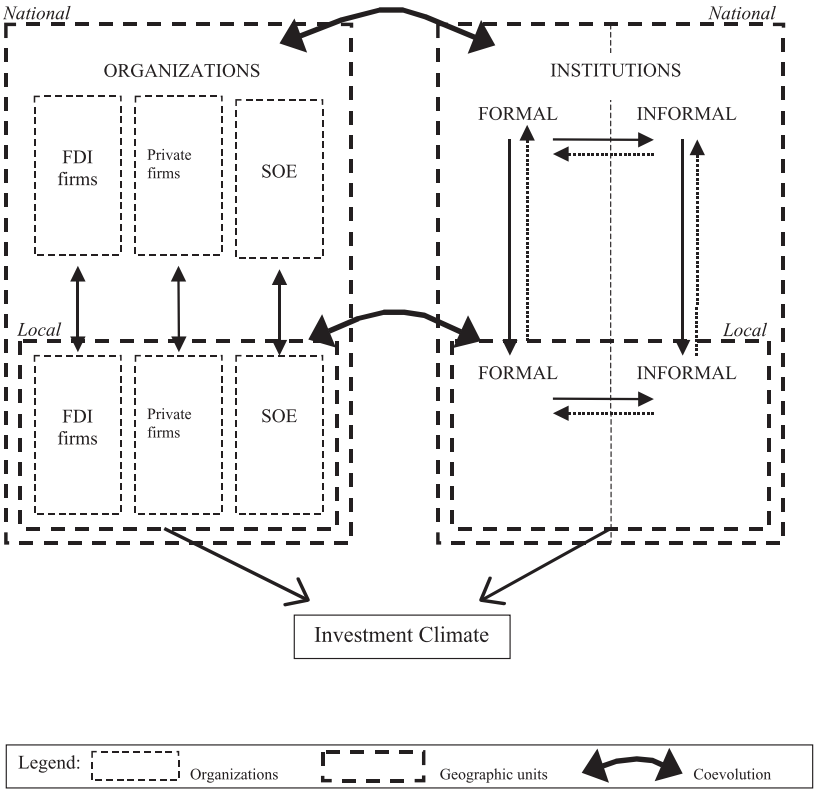
Institutional economics has explored how the institutional set-up influences economic activity (North, 1990) and thus the strategies pursued by firms. This literature distinguishes formal institutions, such as laws and regulations, and informal dimensions that are grounded in customs, traditions, and codes of conduct. In the sociology literature, Scott (1995/2001) describes institutional frameworks as consisting of three pillars : regulatory, normative and cognitive institutions, where the regulatory dimension roughly corresponds to formal institution in North's terminology.

These institutions are mostly analysed at a national level, but they may vary within a country as well. Some countries allow regional authorities to set certain laws. Moreover, even where local authorities do not have law-setting authority, informal institutions may vary due to variations of normative or cognitive aspects of institutions.

Foreign investors thus face a complex institutional environment with both formal and informal aspects. Figure 3.1 presents our

Figure 3.1

Investment climate and co-evolution of national and local institutions and organizations



conceptualisation of the institutional framework faced by foreign investors. It is based on the notion of formal and informal institutions as introduced by North (1990) and the co-evolution of institutions and organisation, as analysed by Lewin *et al.* (1998). Moreover, we have added to the prior theoretical work by elaborating on the interaction between institutions and organisations at national and local levels.

The power of local authorities arises from both formal institutions and informal institutions, such as the effectiveness of implementation of centrally mandated economic reforms. In industrialised countries with a federal structure, such as Australia, Germany or the USA, the responsibilities of different levels of government are clearly deliminated by law. In contrast, emerging economies have formal institutions are somewhat vague, such that the actual influence of provincial authorities is to a much higher degree based on informal institutions.

Many national governments, including Vietnam, may have adopted favourable attitudes to FDI, yet the implementation of these policies is often local. Foreign investors have to negotiate with local authorities over business licenses, real estate, access to public utilities, and in some countries also tax incentives and subsidies. Such policy variation is related to administrative decentralisation, as local authorities can decide how to implement policies set at central level. (This does not necessarily require political autonomy). Informal local institutions draw on distinct local traditions and cultures, may thus show some degree of variations of normative values.

Organisations and institutions co-evolve (Lewin *et al.*, 1998; Peng, 2000). Firms gravitate towards organisational forms for which

they find institutional support. For individual firms, institutions may be exogenous but the population of firms creates pressures to create institutions that best meet their needs. Thus, political and social institutions determine the nature of firms, and the firms support the institutions they come to reply on (Hall and Soskice, 2001).

Feedback effects emerge from local to national levels, and from informal to formal institutions (indicated by dashed lines in Figure 3.1). Lawmakers and ministries are subject to institutional pressures to adjust the legal framework to the expectations of influential groups. In a democracy such pressures are channelled through parliaments as well as informal channels such as lobbying, while in less democratic societies, informal channels may dominate. While developing incrementally, at critical points, informal feedback from below may lead to major reform in formal institutions, such as the revolutions that occurred in Eastern Europe around 1989.

4.2. Institutional Change Processes

Initial reforms concerned first and foremost formal institutions at central level. When the regulatory framework is changed at the centre, this directly affects formal institutions at local level. However, the informal institutions adapt only with considerable delays, and be a major source of inertia (North, 1990). We propose to model these changes of institutions in the following way (Figure 3.2). Reform formally starts with legal changes of the formal institutional framework. Yet new laws do not stipulate everything, and reform thus creates space for administrative decisions at lower levels of the public sector. Individual bureaucrats have some degree of autonomy within the scope of interpretation of new laws due to

lack of legal precedent in applying the new law.

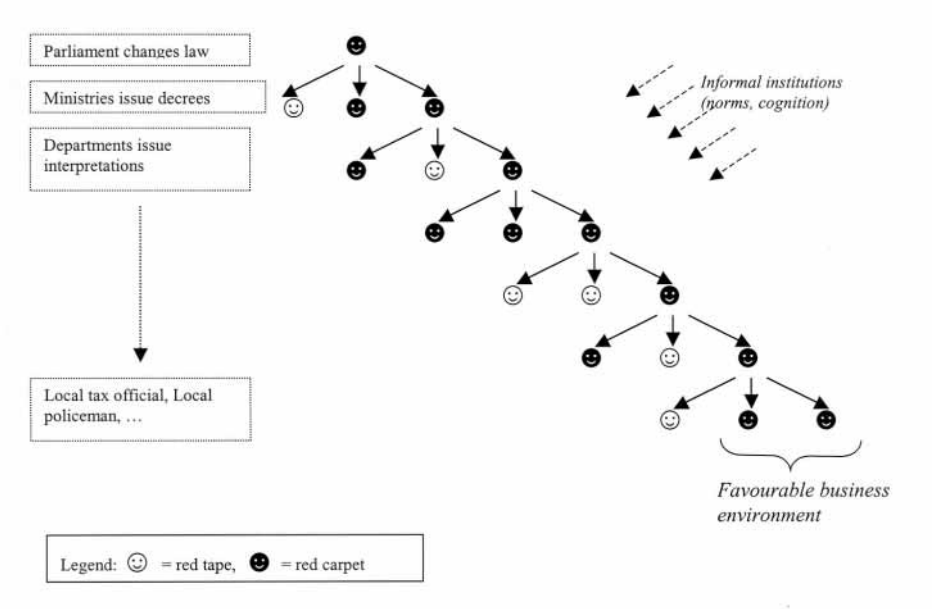
Let us depicts each bureaucrat's decision as choice between interpreting the law in a restrictive, incumbent-protecting or self-serving way, or in a business-friendly way allowing for entry and dynamic market forces. We refer to these two options as '*red carpet*' and '*red tape*'. The *red carpet* treatment may imply enforcement of law supporting in a market economy, and rejection of traditional networking based strategies. It also includes local authorities developing innovative approaches to solving emergent obstacles to business, without waiting for decisions by central authorities, potentially even creating templates that are later adopted elsewhere in the country.

In a complex public sector, many decision makers influence the implementation of institutional change, each choosing between *red carpet* and *red tape* treatment based on his/her individually held norms and cognition. Thus, « simply enacting market-friendly rules is not enough. The next hurdle is their enactment » (Peng, 2003). If conservative inherited norms and lack of recognition of the purpose of regulatory changes dominate, then businesses may experience a lot of *red tape* at local level. Similarly, corruption creates *red tape*. On the other hand, equally possible is a *red carpet* treatment at the local level to the limits of what new legislation permits. Figure 3.2 illustrates the varying decisions at multiple points in an administrative system, which leads to a favourable investment climate in some locations, but not necessarily across the country.

Note that we placed normative and cognitive institutions above the hierarchy of the formal structure. Individuals taking decisions are subject to their individually and socially held norms as well as

Figure 3.2

Implementation of reform:
A formal-informal institutions interpretation



their cognition of the issues at hand. In this way, local history and traditions as well as particular old and new cultural influences affect the institutional set-up that governs business. These informal aspects of institutions tend to be more stable and do not adjust quickly to changes in the legal framework (North, 1990; Peng, 2003). However, they allow for individual entrepreneurial initiative. While changes in the formal framework being observable while informal aspects may be less transparent.

Thus, the inherent ambiguity of laws and regulations issued centrally assigns local authorities an important role in establishing how rules are implemented. The local business climate is thus an outcome of many decisions taken by individuals at various places in society. Formal legislative changes initiate institutional change, yet cognitive and normative institutions have a strong moderating influence on the actual local institutional framework.

5. Empirical Evidence

5.1. The pattern of FDI

FDI in Vietnam is highly concentrated in and around two economic hubs (Figure 3.3). The South-East Region around Ho-Chi-Minh-City (HCMC) has received 2739 FDI projects in the period 1998-2002, and thus accounts for 63% of all projects. Within the region, the province of HCMC alone accounts for 1391 projects, with most of the remainder accounted for by provinces directly neighbouring HCMC to the North. These provinces had little industrial infrastructure in the 1980s, but dramatically increased their share of FDI in the late 1990s.

In the North, most FDI is located in Hanoi province (567 projects), or in the coastal provinces Haiphong (142) and Quang Ninh (75 projects). Here too, we observe a trend over time from the city of Hanoi to greenfield sites outside the city limits. On the other hand, many of the 61 provinces in Vietnam received very few projects, as 10 provinces received less then four projects.

This pattern of FDI is driven both by traditional location advantages and agglomeration effects as well as the institutional framework at province level. On the basis of recent survey data (Estrin and Meyer, 2004), we have analysed both the determinants of locations of FDI, and investors' propensity to choose greenfield entry rather then joint ventures (Meyer and Nguyen, 2004), and find that :

- Provinces with industrial zones attract more FDI; yet beyond the establishment of zones,[16] the availability of real estate in such zones attracts FDI, and greenfield investment in particular. This effect persists even when controlling the agglomeration benefits created by past FDI. Provincial authorities providing land to industrial zones not only create real estate markets,[17] but they also signal a commitment to creating a favourable investment climate.
- Incumbent state-owned enterprises appear to influence the institutional framework such as to encourage foreign investors to partner with them, yet they do not have a significant

16. The establishment of industrial zones requires case-by-case approval by central government authorities, they are thus also an outcome of local initiatives. If successful in lobbying the central government to approve an industrial zone, the province can also offer certain tax benefits for businesses investing in the zone.

17. In Vietnam, real estate markets are underdeveloped as foreign investors may not normally acquire real estate or land use rights.

deterrent effect on FDI. Weak SOEs may thus see JVs primarily as means to enhance their competitiveness, rather than a threat to their market position.

- Institutions establish the range of permissible strategies, including industries open to FDI, investment locations, and entry modes. In Vietnam, the FDI-law did not permit acquisitions for foreign investors, except for special cases such as acquisitions from other foreign owners. This reduces the options for entry modes, and may thus deter some investors.
- Investors' exposure to local institutions varies with the investment objectives. We found that early entrants and local market oriented businesses, which are more likely to encounter conflicts with local incumbents, are more likely to enter by JV.

Overall, this empirical analysis illustrates that institutions at provincial level in Vietnam – in addition to national institutions – affect foreign investors entry strategies. Certain institutional conditions – such as local firms controlling access to critical resources – may inhibit some investors, but induce others to overcome these institutional barriers by establishing a JV.

5.2 Case Study of Dong Nai province

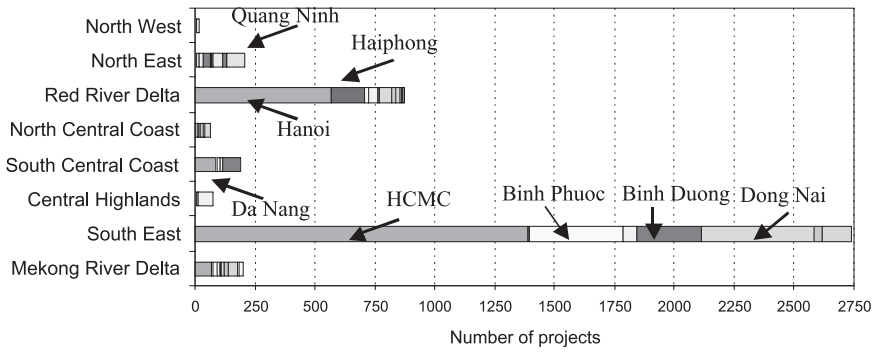
We have interviewed businesspersons and government officials in one of the provinces that attracted much FDI, and often in form of greenfield projects: Dong Nai. The province has inherited some industrial infrastructure, having been an industrial production area before reunification of Vietnam in 1975, then known as Bienhoa Industrial Zone. After the country reopened to FDI in the late 1980s, the relatively good infrastructure and the proximity to

HCMC attracted some foreign investors to the province.

Yet, initiatives of the local authorities made the province a prime destination for FDI. In the early 1990s, Dong Nai developed master plans for multiple industrial zones. In 2001, 10 zones covering 2,725 hectares had been opened and occupancy rate reached 55.31%. Foreign investment surged: by the end of 2002, Dong Nai had 476 projects with total registered capital of US$4.3 billion, and employing over 100,000 people. Taiwanese investors are the largest group of investors with 118 projects (US$ 1.5 billion), followed by Japanese with 35 projects (US$ 838 million).

Beyond the establishment of industrial zones, the provincial authorities aimed to create a *red carpet* for foreign investors using

Figure 3.3
Location of FDI in Vietnam



Data source: Statistics Publishing House (2004a)

both formal and informal means. Businesspersons operating in the province pointed out the following aspects :

- Local authorities provide a timely, clearly and consistent interpretation of laws and regulations. Elsewhere, foreign investors may complain about uncertainty created by inconsistent application of the law, but in Dong Nai, they would know the 'rules of the game' before committing to invest.
- The local authorities have created flexible mechanisms to facilitate the process of obtaining investment licenses. In some cases, the chairman of the Provincial Peoples Committee (effectively, the provincial governor) accompanied investors in person to support investment plan in front of higher authorities. Such visible commitment is highly appreciated by investors.
- First try, report later: Local authorities took a pragmatic approach in some incidences where the formal regulations were too complicated without providing clear benefits. They applied them in a simplified form, and only later reported to higher level of authorities to have formal rules amended.
- The authorities support FDI enterprises beyond issuing investment licenses, for instance by providing advice on how to deal with the complex regulations on import, export, labour recruitment, construction, land lease, etc.
- Within their authority, local authorities provide favourable terms with respect to, for instance, land lease rates and tax rates.
- Last not least, the infrastructure has been developed in line with needs of foreign investors, including transport, electricity, water supply, and human capital.

The relative attraction of Dong Nai as investment location can thus be attributed to a combination of favourable initial conditions, and investor-friendly development of formal and informal institutions at local level. The local authorities, not withstanding their association with the communist party, thus acted as entrepreneurs, sizing the opportunities created by national reform, and advancing capitalist economic development. They matched the *red carpet* offered by the central government by rolling out *red carpets* locally.

In recent years, other provinces follow the lead of Dong Nai, which strengthens the decentralisation of Vietnam. However, Dong Nai benefits from a first-mover advantage and has become the core of a foreign investment cluster outside the traditional hub of HCMC.

5.3. Risks of Decentralisation

While decentralisation creates opportunities for entrepreneurial local authorities, it is also a risky political strategy. The success of the reform depends on decisions made in the provinces that are – by definition – not centrally controlled. The main risks include the possibilities of insufficient administrative capabilities, or self-serving policy decisions made to protect local interests or creating rents for the officials in charge (popularly known as bribes).

Moreover, decentralisation of authority also implies that rules may be different across the country. This is of great concern to some businesspersons. Our interviews with foreign executives in Vietnam point to some of the increased transaction costs associated with decentralisation :

- An executive of a large Hong Kong based trading house was concerned about different product classification in different

ports. If a given product is classified slightly differently, this may trigger the application of a different tariff rate. Thus, importers are very concerned through which port they import to Vietnam as it affects the tariff rates to be paid.

- A manger in an international IT firm has to explain to their customers why they have to pay different rates for the same IT training course in respectively Hanoi and HCMC. This is because they have to charge value-added tax (VAT) in one city but not in the other, as a result of the course being classified a « education service » only in one city, which triggers VAT exemption. This creates additional administrative costs, and confuses customers that operate in both cities.

Thus, decentralisation opens opportunities for local authorities to press ahead with institutional reform, thus creating templates for others to imitate. Yet such uneven progress of reform also creates transaction costs that may inhibit business development, both because of additional risks of institutional changes, and because of adjustment costs for businesses operating across multiple provinces.

6. Policy Implications

Decentralisation is a double-edged policy, creating both opportunities and risks for economic reform, and for the attraction of foreign direct investment. In this chapter, we have outlined the opportunities for facilitating foreign investment by allowing local authorities to take initiatives, and we show that the substantial variation of FDI within Vietnam is to a large extend induced by the diverse development of informal institutions and the uneven imple-

mentation of reform initiatives. Provinces that pursue FDI-friendly policies in the liberalisation process, such as Dong Nai, may benefit from first-mover advantages in the long run, and develop into a hub of economic activity (see also Graham, 2004).

Thus policies to improve the investment climate in emerging economies ought to incorporate both reform at the national level, and means to encourage local authorities to pursue policies in the same spirit of reform. Decentralisation can lead to competition between regions for FDI, but also to central government rolling out the *red carpet*, while bureaucrats in specialist ministries or local authorities create *red tape*. Decentralisation of FDI-related responsibilities thus requires development of institutions at the local level. This can take many forms.

- Technical assistance may support the creation of administrative capabilities at local level, for instance by training local officials.
- A common institutional framework may inhibit excessive « competition by subsidies » (Oman, 2000), or a 'race to the bottom' in labour standards (Spar and Yoffie, 1999), and provide monitoring mechanisms that prevent self-serving administrative governance and corruption.
- Rather then finding case-by-case solutions for each investor, authorities would be better advised to develop the general legal framework governing business. This would both improve transparency and reduce institutionally-induced uncertainty.
- Beyond changing formal institutions, reform minded government may aim to influence informal institutions: Don't just change of the law, but build political support, and create awa-

reness for the benefits of new rules. For example, it does not suffice to declare a special economic zone; rather the quality of the entire institutional framework pertaining to the zone is crucial to attract FDI.

- Incentive systems may allow provinces to retain the benefits of accelerated economic development, such as tax revenues. At the same time, incentives for individual decision makers should discourage them seeking private benefits at the expense of social benefits.
- The *horizontal* exchange of information and experiences between provinces and middle-levels in ministries should be encouraged. In other words, the highly departmentalised structure of the public sector in Vietnam should be opened to facilitate cross-departmental and cross-provincial communication and learning.

While our research has been conducted in Vietnam, we believe that the policy lessons are also relevant for other developing countries that are large and administratively decentralised. Many countries, including China and India, have seen a very unequal distribution of FDI with focus on a small number of locations, and are concerned about attracting FDI to other places. If done well, they may benefit from decentralisation of policy responsibilities to allow local authorities to take their own entrepreneurial initiative.

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Comments

by Curt Nestor
Göteborg University

This paper highlights an important but often ignored research issue, the role of institutions in attracting FDI at the subnational level. The quality of the investment climate plays an important role in the location decision of many investors. The role of administrative procedures and barriers, *i.e.* the impacts of « red carpet » or « red tape » treatment of business activities, can significantly influence the location of foreign invested enterprises and their resulting productivity. However, whereas formal and informal institutions matter, the role of traditional determinants of FDI such as infrastructure, resource endowments and geography, should not be underrated when explaining the spatial pattern of FDI in Vietnam.

The regulatory environment and state management of FDI activities has been in a constant state of « consolidation », « streamlining » and « co-ordination » ever since the inception of the FDI law in 1988. In spite of major improvements over time, the Vietnamese investment environment is still very much characterised by opaque, inconsistent and frequently changing (even retroactive) regulations. This is a recurrent complaint from foreign investors and the problem is frequently acknowledged by top-ranking Vietnamese government officials.

As pointed out in the paper, FDI in Vietnam is highly concentrated to a few provinces, primarily in areas surrounding Ho Chi

Minh City in the South and Hanoi in the North. This should come as no surprise as these urban centres, together with Da Nang in central Vietnam, constitute three key economic areas, an integral part of the national development strategy since the early 1990s. These areas provide the best physical and social infrastructures, proximity to port facilities, and also comprise major population concentrations. Efforts to lure foreign investors to other more remotely located provinces have largely failed due to inadequate infrastructure and other supporting institutions.

However, the potential and real power of Vietnamese state agencies to influence the choice of mode and location of foreign invested enterprises needs to be further emphasised in the paper. In fact, the mode of entry is often mandatory depending on the type of activity. FDI in e.g. construction, heavy industry, and hospitality business such as hotels and other service related activities, typically requires a joint venture (JV) partner. Initially, special incentives were granted to JVs, policies that were extended to also comprise greenfield enterprises (100 % foreign owned) from 1992. No doubt, foreign investors joined State Owned Enterprises (SOEs) in JVs in order to access scarce resources including government contacts. In such cases, the geographic location of the FDI project can be considered as predetermined, as most projects would locate in existing premises of the selected JV partner. At best, the foreign investor were presented with a limited number of potential SOE partners for the proposed project, in fact a small subset of available SOEs, limited to those deemed most appropriate by the government agency in charge. In this way, a number of foreign investors entered JVs with partner SOEs located in the North. Furthermore,

in this context, it is also important to distinguish between the type of FDI activity, broadly manufacturing and non-manufacturing activities, due to different locational requirements and restrictions on mode of entry.

From 1997, licensing procedures devolved to the provincial level within certain scope and restrictions, and a more liberal attitude towards 100 % foreign owned enterprises has generally been adopted. Much attention has been directed towards problems of foreign investors to obtain the investment license. Today, this is often the least problem, in many cases a relatively simple procedure where a license may be issued within a few days, even hours. However, post-licensing procedures are still cumbersome and time consuming, sometimes requiring a large number of additional permits and approvals in order to start a FDI project.

The development of Industrial Zones (IZs) plays a vital role in the foreign manufacturing sector today. The number of zones mushroomed during the latter half of the 1990s and today, there are more than 100 zones officially approved, of which less than one half are in operation. The IZs are mainly located in the three key economic areas and the IZs in the South have been especially successful in attracting FDI. Many provincial leaders see IZs as a panacea to ailing economic development trying to emulate the relative success of IZs achieved in a few provinces. IZs offers simplified procedures free of JV requirements, in principle a one-stop shop for FDI, partially insulating FDI activities from the bureaucratic maze generally surrounding FDI outside the zone. However, the mere existence of IZs cannot be used as an indicator of pro-business friendly environment. Not all IZs are equally successful, and in

many cases they only make part of future visions of provincial development plans due to lack of funds.

The paper would also benefit from highlighting the importance of the poor informational environment and inherent uncertainty in Vietnam. In order to make informed assessments about the Vietnamese FDI climate, rational foreign investors are likely to closely observe the actions of other foreign investors. The perception of the business climate is often based on the accumulated experience, the relative success or failure, of past investments by established foreign investors. The reputation developed of the de facto treatment of foreign investors in individual provinces is an instrumental indicator of the quality of the local investment environment, thus reinforcing the herding effect of FDI.

Decentralisation has provided provincial authorities with ample scope for flexible interpretation of central directives. However, there is a remarkable diversity in outcomes among the provinces. Some provinces made efforts to accommodate foreign investors' needs and developed a reputation as especially business friendly, e.g. Dong Nai and Binh Duong in the South, whereas others are reputed for unfavourable business climate, *e.g.* Hai Phong in the North. However, the case-by-case treatment applied to resolve immediate and pressing problems for foreign investors does not promote transparency. It may yield different results for different investors and does not necessarily lead to more permanent and viable solutions.

Chapter 4.
Foreign Ownership and Wages : *Evidence from East Asia and Africa*

Dirk Willem te Velde and Oliver Morrissey[18]

1. The issue

Foreign Direct Investment (FDI) is an important source of private capital for developing countries. The UN conference on Finance for Development (FfD) argues that 'private international capital flows, particularly foreign direct investment, along with international financial stability, are vital complements to national and international development efforts' (Draft Outcome: point 20, p. 5). Other international policy documents (e.g. the Cotonou Partnership Agreement, NEPAD) also emphasise the importance of private sector investment, both domestic and foreign, for development, and FDI features prominently in the UK White Paper *Making Globalisation Work for the Poor* (DFID, 2000).

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18. This paper is a revised and updated version of " Foreign Direct Investment. Who Gains ? "

an ODI Briefing paper, see http://www.odi.org.uk/publications/briefing/bp_may02.pdf. Additional technical details are available in Te Velde and Morrissey (2003 and 2004). Dr te Velde is a Research Fellow at the Overseas Development Institute ; Dr Morrissey is Professor of Development Economics and Director of CREDIT, University of Nottingham and a Research Fellow at the Overseas Development Institute. Comments: dw.tevelde@odi.org.uk

An issue of current interest is whether FDI can contribute to the objective of reducing poverty. This will depend on how the gains from FDI are distributed, among sectors, workers and households. Systematic evidence on the effects of FDI on income distribution and poverty in developing countries is emerging. In principle, there is no direct link between FDI and poverty, except through socially responsible investment such as funds for education, health, small scale economic activities or direct « compensation » for the poor in the neighbourhood of an investment. There are four possible indirect links.

• If FDI contributes to economic growth, it supports increases in national income that offer the potential to benefit the poor. In this case it is not FDI that reduces poverty, but it helps create an enabling economic environment.

• Foreign firm may introduce new products to the economy. If these are higher quality and affordable by the poor, this will help to alleviate poverty.

• If FDI increases employment it may help some to move out of poverty. FDI in manufacturing is likely to employ labour that is relatively skilled (in terms of the local market), and would not directly benefit the poor, but the second round effects can be considerable. FDI in primary sectors (except the gas and oil sectors) is more likely to employ unskilled labour and to provide benefits to rural areas and could reduce poverty in those areas.

• Foreign firms may pay higher wages than local firms for workers with similar qualifications. This will not directly affect the poor and is likely to increase inequality of wage incomes, increasing the skilled/unskilled wage differential, and to increase urban/rural

income differentials. However, by establishing a better skilled and higher paid labour force, it should increase incentives and effort and can generate dynamic benefits to the economy.

The evidence that FDI contributes to economic growth is encouraging rather than compelling (Lensink and Morrissey, 2000), and growth itself does not guarantee poverty reduction. The poorest countries, such as those in Africa (that receive a very small proportion of FDI), are also the least able to derive growth benefits. One cannot simply assume that FDI will contribute to poverty reduction through fostering growth in poor developing countries.

If the foreign investment represents additional investment it should provide employment. This benefits workers and the economy in general, and may benefit some of the poor. Foreign firms tend to be larger than local firms, hence the presumption that greenfield investment increases employment. However, increasing amounts of FDI are for mergers and acquisitions, such as buying privatised firms, and this may not necessarily increase employment. If foreign firms are more capital intensive, employment levels will fall (although labour income may rise). If they compete with local firms, employment may be reduced elsewhere in the economy. Unfortunately, there is little systematic evidence of the employment effects of FDI.

This paper concentrates on the third channel identified above, namely the effect of FDI on incomes of different groups of workers, as an indication of how gains are distributed. The evidence focuses on the differential impact of FDI on workers, specifically on wages. Depending on the distribution of different types of workers over rural and urban areas and over small and big firms, the findings have wider policy implications.

2. The impact of FDI on different types of workers : theory

Foreign-owned firms, the manifestation of FDI, influence distribution of incomes partly because they demand different types of labour and pay higher wages than local firms. In general, one can focus on effects for skilled versus low-skilled or unskilled labour. At a global level, some FDI is attracted to countries that are abundant in unskilled labour relative to other countries (other FDI is attracted by natural resource endowments or policy factors). However, the foreign firms may still employ labour that is relatively skilled by local standards. There are a number of reasons why one would expect FDI to increase the demand for, and wages of, relatively skilled labour.

- *Skill-specific technological change*. In addition to initial efficiency differences, FDI could induce faster productivity growth of labour in both foreign (technology transfer) and domestic firms (spill-over effects).
- *Skill-specific wage bargaining*. Skilled workers are usually in a stronger bargaining position than less-skilled workers, as they posses key skills in relatively scarce supply and may have better negotiation skills, and can get higher wages. As foreign firms have less knowledge of the local labour market, skilled workers are in a position to negotiate higher wages than they would get in local firms.
- *Composition effect*. Foreign firms may have different skill intensities from domestic firms pushing up the average skill intensity. If FDI causes a relative expansion of skill intensive sectors, this will improve the relative position of skilled workers and raise wage inequality.

- *Training and education*. FDI may affect the supply of skills through firm-specific and general training and through contributions to general education (see Te Velde, 2002).

The above factors are each complex and potentially interrelated. The effect of FDI on relative wages and employment will vary between sectors and across countries.

3. The impact of FDI on different types of workers : evidence

Almost all evidence shows that FDI and foreign ownership are associated with higher wages for all types of workers. Skilled workers tend to benefit more than less-skilled workers (for any or a combination of the reasons outlined above). Studies of the link between FDI and wages fall into two broad types and two technical papers mirror this distinction. In the macro context we incorporate the effects of FDI in a national labour demand equation, derived from a production function that distinguishes between skilled and less-skilled workers, through the effects of wage bargaining and skill-s pecific technological change. The possible simultaneity bias between FDI and skills has been accounted for through instrumental variable estimation. In the micro study, we compare earnings of employees in local and foreign firms by using data linking firm and worker characteristics.

Macro studies

The relationship between FDI and wages at the country level will amongst others depend on the sectors in which FDI is directed. Table 4.1 shows the sector distribution of FDI in five East Asian countries. FDI in Hong Kong and Singapore has been mainly aimed

at the financial sector, which is relatively skill intensive. In Korea, most of the relatively little FDI it has received was in manufacturing. The manufacturing sector in Thailand and Philippines also absorbed most FDI. Thailand in particular attracted a quarter of FDI flows in the capital-intensive and relatively skill-intensive chemical, machinery and electrical manufacturing sectors. The table shows that the skill–intensive sectors overall did attract significant FDI flows in all five East Asian countries, implying that the FDI-composition effect is unlikely to have reduced wage inequality.

Table 4.1
Distribution of FDI stocks in East Asia by sector (%)

	Hong Kong (flows 1997)	Korea (accumulated flows 1962-1998	Singapore (stock of foreign direct equity investment, 1998)	Thailand (accumulated flows over 1970-2000	Philippines (accumulated flows 1985-1999)
Agriculture and Mining	0	0	0	1	7
Manufacturing	2	59	33	42	48
Construction		1	1	5	4
Trade	28	10	15	19	8
Services	70	30	52	33	34

Source: Te Velde and Morrissey (2004).

Te Velde and Morrissey (2004) focus on a panel of East Asian countries and discuss the relationship between the stock of FDI as a per cent of GDP and skill-specific wages (controlling for other determinants of skill-specific wages, such as employment effects, unionisation rates and trade, and using SUR IV estimation). It may be expected that FDI would locate in countries such as Thailand and Philippines to avail of abundant low-skilled labour. Employing low-skilled workers would help to reduce wage inequality. However, the results indicate that while FDI benefited both skilled and low-skilled workers to the same extent in four Asian countries (Hong Kong, Korea, Philippines and Singapore), it benefited more skilled workers in Thailand (the coefficient on FDI is much higher for skilled than for less-skilled workers. Details for one specification, which controls for wage rates and skill-specific technological change, can be found in table 4.2.

Table 4.2

FDI and skill-specific wages in East Asia (1985-1998)

$$\ln(\frac{w_U}{P})_{it} = \alpha_{1i} + \beta \ln(\frac{U}{Y})_{it} + \gamma\, t + \gamma_{2i} fdis_{it} + \varepsilon_{it}$$

$$\ln(\frac{w_S}{P})_{it} = \alpha_{2i} + \beta \ln(\frac{S}{Y})_{it} + \gamma\, t + \gamma_{2i} fdis_{it} + \varepsilon_{it}$$

	Low-skilled wages	Skilled wages
	(SUR IV estimation)	
β	-0.38 (-48.1)*	-0.36 (-48.1)*
Time trend	0.003 (0.63)	0.014 (1.96)*
$\gamma_{2,HK}$	0.54 (2.01)**	0.54 (2.01)**
$\gamma_{2,KO}$	35.3 (1.77)**	73.0 (2.27)*
$\gamma_{2,SP}$	0.54 (2.01)*	0.54 (2.01)*
$\gamma_{2,PH}$	0.54 (2.01)*	0.54 (2.01)*
$\gamma_{2,TH}$	0.54 (2.01)*	4.12 (3.09)*
Observations	48	
Parameters (excl intercepts)	7	

*(**) significant at 5% (10%) level; instruments include "own" variables and changes in FDI regime.

Source: Te Velde and Morrissey (2004).

Freeman *et al.* (2001) find no evidence for a consistent relation between FDI and wage inequality in a sample of developing countries. Feenstra and Hanson (1995) find that inward FDI increased the relative demand for skilled labour in Mexican manufacturing over 1975-1988. Te Velde (2003) provides further evidence for Latin America using similar techniques as in the case of East Asia arguing that FDI raised wage inequality in Bolivia and Chile, while having no to very small effect in most other Latin American countries.

Micro studies

To determine the true effect of foreign ownership on wages, one must control for other determinants of wages. The most important control variables are skill intensity, size, regional and sector dummies. Foreign firms are likely to employ relatively more skilled labour, so average wages will be higher (see above). One should therefore compare wages of workers with equivalent qualifications. Foreign firms tend to be larger than local firms, and large firms pay more for equivalent workers than smaller firms do (Strobl and Thornton, 2001), so one must control for size. One should control for industry type as foreign firms locate in particular industries (Aitken *et al.,* 1996, Aitken and Harrison, 1999), in which wages may be higher. Similarly, foreign firms locate in areas, such as the capital city, where wages may be higher so one should control for location. Ideally, one would also try to control for firm-level efficiency as labour productivity may be higher in foreign firms.

Empirical evidence on wage differentials summarised in table 4.3 conveys three important conclusions :

- Foreign-owned firms pay more to their workers than local firms.

Table 4.3
Wage differentials between foreign-owned (FOE) and local firms

Study	Country, year	Dependent variable	Controls	Results
Africa				
Haddad and Harrison (1993)	Morocco, manufacturing firms, 1985-1989	Average wage level in firm	Size	FOE pay 30 per cent more
Mazumdar (1995)	Cameroon, and Zambia	Earnings	Worker and firm characteristics	FOE pay 18% more in Cameroon and 24% in Zambia.
Te Velde and Morrissey (2003)	Cameroon, Ghana, Kenya, Zambia and Zimbabwe (manufacturing firms)	Average monthly earnings	Worker and firm characteristics	FOE pay higher wages - Cameroon (8%), Ghana (22%), Kenya (17%), Zambia (23%) and Zimbabwe (13%).
Asia				
Lipsey and Sjoholm (2001)	Indonesia, manufacturing plants, 1996	Average wage per employee	Worker and firm characteristics	FOE pay 12% more to blue collar and 22% more to white collar workers.
Lipsey and Sjoholm (2002)	Indonesia, manufacturing plants, 1975-1999	Average wage per employee	Firm characteristics	FOE pay 29% more to blue collar and 43% more to white collar, but there are differences relating to different specifications. Foreign takeovers led to higher wages.
Matsuoka (2001)	Thailand, manufacturing, 1996 and 1998	Hourly wages	Labour productivity, region and industry dummy	FOE pay 20% more for non-production and 8% for production workers in 1996; 28% and 12% for 1998.
Ramstetter (1998)	Hong Kong (1983-1996), Malaysia (1972-1979, 1981-1995), Singapore (1975-1996), Taiwan (1974-1995), manufacturing plants/firms	Real compensation per employee		FOE pay higher wages in Hong Kong (27%), Malaysia (20%), Singapore (9%), Taiwan (16%)
Other developing				
Aitken, Harrison and Lipsey (1996)	Mexico (1990) and Venezuela (1987),	Wage of skilled and unskilled	firm, industry and region dummies	FOE pay 29% per more in Venezuela, and 22% in Mexico (skilled); 22% more in Venezuela and 3.3% Mexico (unskilled)

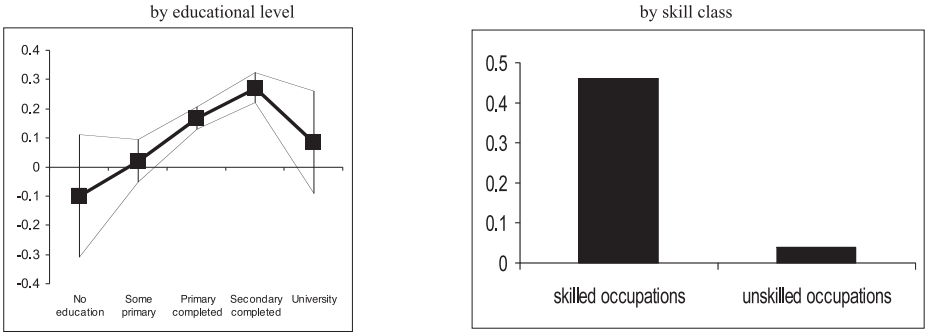
Wage differentials can be up to 60 per cent (Indonesia), but more often are more modest.

- Studies that do not control fully for other effects overstate the effect of foreign ownership on wages.
- Studies that distinguish between average wages in two separate skill categories find that wage differentials are greater for non-production (relatively skilled) workers than for production (less skilled) workers.

Te Velde and Morrissey (2003) find that foreign ownership is associated with higher wages at the individual worker level in the manufacturing sector of five African countries after controlling for other influences on wages. Foreign ownership is associated with a 20-40 per cent differential in individual wages (conditional on age, tenure and education) on average. This is halved to 8-23 per cent if it takes into account the fact that foreign-owned firms are larger and locate in high-wage sectors and regions. Secondly, there is a tendency for more skilled workers (using occupation and education categories) to benefit more from foreign ownership than less skilled workers, and this conclusion holds after accounting for the size distribution of foreign firms. Figure 4.1 shows this more clearly for the entire sample.

The observation that skilled workers tend to benefit more than less-skilled workers may be because foreign ownership is associated with skill-biased technology or because skilled workers in foreign firms are more effective in bargaining. In practice it is difficult to distinguish between these effects, and it is likely that an element of both is present.

Figure 4.1.
Difference (%) in PPP wages between workers in foreign and local firms



Dots are estimated differences. Thin lines delineate 95 per cent confidence interval around estimated values

Source: Extended version of Te Velde and Morrissey (2003). Results are based on regressions that include control variables and pool observations for all five countries (10285 observations).

4. Implications for policy

Governments try to attract FDI for expected beneficial effects on employment, wages, balance of payments, technology and growth. They are not usually, or at least have not been in the past, concerned with effects on inequality or poverty. Furthermore, FDI is only one of many factors affecting skill-specific wages and wage inequality. Others, some of which were considered as controls above, may be more amenable to influence by government policy. This includes education, training and technology transfer.

The African and East Asian studies reviewed above suggested that foreign ownership or FDI does increase wages, but more so for skilled workers thereby increasing wage inequality. This does not necessarily imply that national income inequality will increase. In general, FDI may have little effect on those at the top of the income distribution, and little effect on those at the bottom (the poor, unless some of these are the unskilled who gain jobs). The effect is to bring some in the middle closer to the top group, reducing inequality, but further from the bottom, increasing inequality. Concern here is not about policies towards inequality or the poor *per se*, but about policies to ensure greater and more equitably distributed gains from FDI.

Host-country policies

The best policies are those that increase the potential for workers and for the economy to benefit from FDI. The former policies relate primarily to education, training and industrial relations. The latter relate to encouraging increased efficiency of domestic firms, to benefit from linkages with and spill-over from foreign firms, and

to attracting FDI into areas or sectors that are most likely to benefit the poor (e.g. rural areas or agricultural processing).

Public and private human resource development policies. Growth in FDI will increase the demand for skilled workers. Good quality and appropriate education in this context requires increased enrolment in secondary education to provide the foundation for vocational and tertiary technical education. Governments in developing countries have tried various schemes to boost enterprise training, but take-up and coverage rates remain low. There is a case for public policy intervention as private firms may not have sufficient incentives to train low-skilled workers. The problem is most severe in the poorest countries that lack adequate resources to finance secondary and vocational training. Foreign firms offer more training than their local counterparts, and should be encouraged to offer more to low-skilled workers. This would be an appropriate element of corporate social responsibility if foreign firms are committed to increasing the benefits for all workers.

Linkage promotion policy If governments want to ensure that some benefits of FDI go to the poor, they will need to encourage foreign firms that employ relatively unskilled labour and/or attract investment in sectors that are likely to benefit the poor. This paper has concentrated on FDI in manufacturing. If there is increased employment of unskilled workers who were poor, the FDI in manufacturing can reduce poverty whilst increasing wage inequality. FDI that supports employment in rural areas and agricultural sectors is more likely to benefit the poor, even if the gains are also unequally distributed. One way to achieve this is by promoting linkages between foreign and local firms.

International community.

The international community has various options. First it should raise the importance of the social dimensions of globalisation, by reiterating the need that *all* benefit from FDI. In doing so, it can support the implementation of the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (which are related to the OECD MNE guidelines on training/industrial relations), setting out principles in the field of employment, training, working conditions and industrial relations. The right of collective bargaining and the need to provide training « for all levels of their employees » seem important in the context of FDI and wage inequality, and more research is needed to examine whether practices differ between foreign and local firms.

Second, the donor community can support developing country's efforts to improve the impact of FDI on wages of low-skilled workers. Support for good quality and appropriate education and general training for low-skilled workers is justified. Donors should recognise the potential benefits from vocational training schemes (an appropriate element of a private sector development programme). They can also use "home country measures" to raise the volume of investment to developing countries and affect the impact of that investment on local productivity growth, employment and wages. One concrete example would be to support business linkages through the establishment of a global business linkage fund (Te Velde, 2002a). This might help to pull in new FDI as well as promote linkages with the local economy.

Whilst it is clear that FDI and foreign ownership are one factor in increasing average wages, skilled workers tend to gain more than

low-skilled workers. Although low-skilled workers do benefit (and therefore the poor may benefit), the tendency for FDI to raise wage inequality may require a policy response. The policy implications can be summarised as follows

• FDI raises average growth and wages, but does not reduce and may increase wage inequality in developing countries. Policy should be aware of whether wage inequality leads to national income inequality.

• Policies to use FDI can be effective in ensuring that FDI works for skilled as well as less skilled workers, and that it is more likely to provide employment benefits to the poor.

• Support for good quality and appropriate education and general training for low-skilled workers is required to make FDI work for development for all type of workers.

• More attention should be focused on the bargaining position of low-skilled workers in a globalising world. Much of the micro-evidence finds that skilled workers in foreign firms are able to obtain a higher wage premium than low-skilled workers, not necessarily because foreign owned firms make skilled workers more productive but because foreign owned firms make skilled workers relatively more effective in wage bargaining.

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Comments

by Matthieu Crozet
TEAM, Université Paris I-Panthéon-Sorbonne

Beyond trade liberalisation issues, globalisation has given rise to great concern among policy-makers and civil society as to the effect of foreign direct investment on employment and wages. Indeed, a worldwide public debate has emerged on whether or not multinational companies close plants in developed countries in order to exploit workers in developing countries (this debate has been raised by NGOs and such activist groups as « Anti-Sweatshop » Campaign in the USA or « De l'éthique dans l'étiquette » in France). More, this issue is crucial for policy-making in developing countries since it determines governments' attitudes towards liberalisation and attractiveness policies.

For these reasons, but also because it puzzles academics researchers in international economics, the impact of FDI on wages is an issue that needs to be explored carefully. In his survey on the effect of globalisation on wages, Robert Baldwin (1994) [19], explicitly says that one needs « *further studies to understand better the employment and wage impact of FDI* ». More recently, Lipsey and Sjöholm (2004) [20] notice that « *on almost every aspect [of the host country impacts of inward FDI]*

19. Baldwin R. E. (1994), « The Effect of Trade and Foreign Direct Investment on Employment and Relative Wages », *OECD Economic Studies* N. 37:7-54.

20. Lipsey R. E., F. Sjöholm (2004). `Host Country Impacts of Inward FDI : Why Such Different Answers ?, in Blomström, M., Graham, E. and T. Moran (eds.) « The Impact of Foreign Direct Investment on Development : New Measurements, New Outcomes, New Policy Approaches », Institute for International Economics, Washington DC.

there seems to be a wide range of empirical results in academic literature and little sign of convergence ». Likewise, Brown, Deardorff and Stern (2003) [21] emphasise that « *available theories yield ambiguous predictions, leaving the effects [of multinational production on wages in developing countries] to be examined empirically* ».

Hence, the contribution of Dirk Willem te Velde and Oliver Morrissey is particularly valuable, especially because they focus on wage inequalities, a topic that is even more original in the economic literature. Their presentation summarise two empirical analyses of the impact of the presence of multinational companies on wages in developing and emerging countries. Using macro data for five East Asian countries, the authors provide evidence that the presence of multinational enterprises (MNEs) is associated with higher real wages for both skilled and unskilled workers. In Thailand, however, MNEs' influence on wages is very skills-biased, as a result of which FDI increases wage inequalities in this country. Similarly, an analysis of micro-data for five African countries shows that MNEs pay higher wages relative to local firms. The authors noted this premium for both high-skilled and low-skilled workers. Here again, FDI seems to widen wage inequality since the benefits are even higher for skilled workers.

These empirical investigations provide very useful clear-cut evidence that FDI may impact negatively on social cohesion. Yet above and beyond this evidence, two main questions arise.

First, the authors base their analysis on a very simple microeconomic theoretical framework. They emphasise the role of technological

21. Brown D. K., A. V. Deardorff, R. M. Stern (2003), "The Effects of Multinational Production on Wage and Working Conditions in Developing Countries", *NBER Working Paper* N. 9669.

spillovers generated by FDI and of an undefined wage bargaining process. Additional theoretical investigations are probably needed to identify clearly the channels that link the presence of MNEs and wage dispersion. Brown, Deardorff and Stern (2003) highlighted that this theoretical issue is not trivial. Most models of FDI provide unclear conclusion about the influence of FDI inflows on inequality. Using a grounded theoretical background should make it possible to improve the empirical strategy and draw acute policy-oriented conclusions. For instance, if the observed relation results mainly from a change in factor proportions and factor demand, the appropriate response is to encourage human capital investment. The response will be different if the increase in inequality is a result of the relatively low bargaining power of less-skilled workers. In this case, improving labour-market institutions is the key to more equitable distribution of gains from FDI.

Second, the authors do not explain sufficiently how this increase in wage inequalities really matters. Indeed, they have proved that FDI is always associated with higher wages, which suggests that the resulting widening of wage gap is Pareto Optimal (the suitable policy should therefore not influence directly the wage gap but rather offset relative losses through the application of a so-called « political Coase theorem »). Moreover, governments should be concerned with income inequality, which is a more general issue than wage dispersion. Hence, future research on the field of the influence of FDI on inequalities should also consider the impact of FDI on non-wage income such as local profits or land rents.

Chapter 5.
Globalisation in a middle income economy:
FDI, production and the labour market in South Africa

Stephen Gelb[18]
The EDGE Institute

1. Introduction

South Africa is a middle-income semi-industrialised economy with an established industrial base and a segmented labour market with very high unemployment. The history of FDI in South Africa is long and complex. London-based banks established the banking system in the nineteenth century, and capital for gold and diamond mining development came from Europe, leading to the establishment of a Stock Exchange in Johannesburg in 1887. British, American and European companies helped to establish domestic manufacturing

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22. A longer version of this paper is to be published as S Gelb & A Black, *"Globalisation in a middle income economy: FDI, production and the labour market in SA",* in W. Milberg (editor), *Labour and the Globalisation of Production* (Palgrave Macmillan, London, 2004). The paper is a product of The EDGE Institute's participation in the London Business School Centre for New & Emerging Markets project on FDI in Emerging Markets.

from the 1920s, avoiding trade barriers and enjoying market growth as white living standards rose. By the 1970s, 40% of FDI was in manufacturing and 25% in financial and business services, with only 15% in mining.

From the early 1970s, few companies entered South Africa or other emerging economies, as FDI declined globally. But opposition to foreign investment was a focus of the international anti-apartheid campaign, and during the 1980s about 225 US corporations and 20% of British firms exited. Nonetheless, when the economy re-opened internationally after 1990, over 450 foreign firms were operating, with about 85% of FDI assets from Europe and 13% from North America.

This paper uses survey data and sectoral analysis to assess FDI in and their impact in South Africa during the 1990s.

2. South Africa during the 1990s

Policy has become far more liberal and outward-oriented during the 1990s, in part to attract new FDI. Domestic policymakers have sought to supplement low domestic savings with capital inflows, preferably FDI because it is less volatile than portfolio flows. The fiscal deficit has been kept below 3% of GDP since 1999 and inflation below 10% since 1993. Average tariff levels were reduced to 7% by 1997. In 1995, restrictions on non-residents' capital transactions were removed, and foreign institutions admitted to the banking and equity trading markets. Some FDI has entered via privatisation, though this has been limited by domestic political opposition and global market conditions.

Well-developed financial markets have attracted substantial

portfolio inflows: in 2000, gross non-resident transactions represented 52% of equity market turnover and 23% on the bond market. Between 1995 and 2002, South Africa received 3.3% of gross market-based capital flows to developing countries and 22% of net portfolio equity flows. But inflows have been volatile, reflected in three currency collapses (in 1996, 1998 and 2001), but also nominal trade-weighted appreciation of 45% since 2002.

Due to capital account volatility, constrained domestic demand and political uncertainty, private fixed investment between 1994 and 2003 averaged only 11.7% of GDP despite improved profitability, and GDP growth a lowly 2.77% per annum (0.77% per annum per capita).

The labour market is highly segmented. About a third of the working age population is not economically active, and less than 40% in employment. The 'narrow' unemployment rate in 2003 was 31.2% (economically active people still seeking work), but 'broad' unemployment was 42.3% (economically active but discouraged from looking). Of those employed in 2003, only 63.6% were in the formal sector, with 7.5% in commercial agriculture and 28.3% in unregistered businesses or domestic service. Unemployment is unequal across race and gender: 49.1% of Africans are unemployed but only 9.5% of whites, and 48.4% of women but only 35.9% of men.

Extremely high unemployment is the result of the historical pattern of industrialisation: capital-intensive production of consumer durables (autos, electrodomestics) and heavy intermediate goods, combined with racial discrimination in labour and consumer markets and in education. By the 1970s, the manufacturing sector was non competitive, labour productivity low and growth declining, and

by the late 1980s, only one in eight new labour force entrants found employment.

High unemployment causes poverty and inequality: in 2000, ten million people (23% of the population) received less than $2 per day, the Gini coefficient was 0.57, and the top quintile received 64.9% of total income compared with only 6.1% for the bottom two quintiles. An estimated 11.4% of the population was HIV-positive in 2002, the world's second-highest prevalence rate.

Employment prospects are closely correlated with education levels, but there has been a substantial 'skills twist' since the mid-1980s. The share of high skill workers in all sectors except construction has grown, while overall job growth has been fastest in high-tech services, slow in manufacturing and declining in primary and government sectors. This reflects changes in the output structure: shares of mining, manufacturing and other industry declined, while services increased. Within manufacturing, labour-intensive sectors grew far slower than capital-intensive, partly linked to trade: exports shifted from minerals to capital-intensive manufacturing and import penetration in labour-intensive sectors increased. Trade structure is perverse, and does not reflect factor endowment: a low and declining share of exports is unskilled labour-intensive, while a high share are capital- and skilled labour-intensive (Lewis, 2001).

3. Foreign Direct Investment in the 1990s

New direct investment since 1994 has disappointed, particularly in light of the emphasis in policy reforms upon attracting it. Gross inflows averaged $1.86 billion *per annum* between 1994 and 2002 (UNCTAD), while net inflows were 1.5% of the developing country

total. [23] On a per capita basis, the inflow was about $41, close to the developing countries' average, though South Africa's per capita income is about 2.5 times larger than the developing country average. South Africa differs from most middle-income countries in receiving far smaller direct investment than portfolio inflows.

In 2002, the London Business School and The EDGE Institute [24] surveyed 162 firms from a sample frame of 516 foreign investors who first entered South Africa after 1990.[25] Table 5.1 shows that 'financial & business services' and 'machinery & equipment' were the two leading sectoral destinations, and adding the latter to the other manufacturing sectors – basic consumer goods, material processing and pharmaceuticals – shows that manufacturing comprises just over half of investment, though its contribution to GDP is just over 20%. Although 10% of the affiliates have more than 1000 workers, they are small on average: the median labour force is only 90 workers and median fixed capital only $1.94 million. This suggests FDI is unlikely to be a significant vehicle for either large capital inflows or direct employment creation.

Employment growth has been relatively good: the median labour force grew by 67% between firms' entry and 2000, and 44% of firms more than doubled their workforce. [26] But about one-third of the firms are in skill- or knowledge-intensive sectors – financial

23. There has been substantial outward FDI from South Africa during the 1990s, especially into Africa.

24. The survey included Egypt, India and Vietnam, and is reported in full in Estrin & Meyer (2004).

25. New investments by firms which entered South Africa during the apartheid era were excluded.

26. Of course, it is net job creation that is ultimately of concern: foreign firms may have increased their labour force by enhancing market share at the expense of domestic competitors who shed workers as a result.

and business services, IT and pharmaceuticals – where size is not correlated with turnover. A significant minority in manufacturing and infrastructure outsourced their South African production activities, focussing on strategic management, marketing and technical services, to mitigate perceived risks, including political and social risk, currency risk and market risk.

Table 5.1

New foreign affiliates. Sectoral distribution and size (2000)

	% of sample (N=162)	Median size of workforce	Median capital stock ($m)
Primary	3	1500	24.50
Basic consumer goods	13	78	0.65
Intermediate goods	17	85	2.45
Machinery & equipment	19	100	2.00
Infrastructure & construction	12	147	0.22
Trade & hospitality	5	220	13.69
Financial & business services	20	70	0.86
Information technology	8	55	1.01
Pharmaceuticals	3	23	0.08
All sectors	100	90	1.94

Source: LBS/EDGE survey.

Nearly 60 percent of the investors are European, including 11% from each of the UK, Germany and France. The European firms are distributed roughly equally across the three manufacturing sectors, infrastructure and financial and business services. The North American firms (22% of the total) are concentrated in materials processing, financial and business services and IT, while East Asian firms (15% of the total) are concentrated in manufacturing, particularly materials processing and machinery and equipment.

The investors range from small multinationals with operations in three or four countries to global giants, of which South Africa already had many present before 1990. The median number of affiliates is 20 and median global labour force is 10250 workers. Only 15% of the investors had no emerging market experience at all prior to entry into South Africa, while more than half were already in three or more emerging market regions, and over a third elsewhere in Africa.

The basic consumer goods sector is dominated by mid-size European firms with a few emerging market affiliates, which see market potential in South (or Southern) Africa. Materials processing investors are small globally, and the South African affiliate is significant within the firm, in contrast to machinery and equipment investors, where perhaps because of economies of scope, investors are large with many affiliates in both industrialised and emerging markets. The infrastructure firms have extensive emerging market experience, probably linked to the wave of privatisations in the 1990s. In financial and business services, firms have many widely-dispersed affiliates with small workforces and low spending on both R&D and advertising, and South African affiliates contribute a very small share to global revenues. Finally, IT firms have a relatively

large number of affiliates and substantial emerging market experience and spend a large share of turnover on R&D.

Mode of entry matters: acquisitions involve smaller additions to capital stock or employment, but can be a vehicle for technology and skill transfer to improve domestic firms' international competitiveness. South Africa was the only one of the four countries in the survey with a high proportion of acquisitions: 31% of entries were full acquisitions and 14% partial acquisitions, compared with greenfields (32%) or joint-ventures (23%). This suggest both that South Africa's market for corporate control is mature and that foreign investors find South Africa's corporate environment familiar. Acquisitions were most common in materials processing and IT, but very few in infrastructure and financial and business services, sectors with regulatory restrictions.

4. FDI and globalized production

Table 5.2 presents the means of affiliates' sales into four distinct markets: domestic, regional [27], global, and other affiliates of the parent, or non-arm's length exports indicating integration into international production chains or networks. The distinction between regional and global exports is important : for many South African firms, regional sales are a « vent for surplus » fluctuating inversely with domestic demand, while global exports are more likely to lead to « learning-by-exporting » productivity improvements (Rankin, 2001); for foreign investors, regional versus global sales are likely to represent alternative motives for investment, market-seeking and efficiency-seeking respectively.

27. 'Region' refers to Southern Africa or Sub-Saharan Africa, depending on the respondent's interpretation.

Table 5.2

Market orientation. Percent of affiliates' sales, unweighted means.[28]

	Domestic Market		Regional Market		Global Market		Other Affiliates	
Sector	Entry	2000	Entry	2000	Entry	2000	Entry	2000
Primary	17	13	10	0	73	87	0	0
Basic consumer goods	94	85	5	7	1	8	0	0
Intermediate goods	84	73	1	6	15	19	0	1
Machinery &equipment	86	77	2	10	6	8	7	5
Infrastructure & construction	67	69	3	7	24	22	6	3
Trade & hospitality	80	82	1	2	19	16	0	0
Financial & business services	84	78	6	10	6	8	5	3
Information technology	85	53	1	26	8	14	7	7
Pharmaceuticals	96	87	4	11	0	0	0	1
All firms	**81**	**73**	**3**	**9**	**12**	**15**	**4**	**3**

Source: LBS/EDGE survey.

28. Since entry dates differ, the change from 'entry' to '2000' should not be interpreted as a growth rate.

Except in the primary and infrastructure sectors, the mean share of domestic plus regional sales is above 75% of turnover. As was true before 1990, foreign firms – other than in mining – entered South Africa during the 1990s seeking markets, but with the strategy extended into the region. Many firms' intention at entry was to use South African markets as a basis for supplying the region (either Southern or sub-Saharan Africa). Many firms reported lower than anticipated sales in Zimbabwe, South Africa's largest regional trading partner at the start of the 1990s, and the crisis in that country has probably reduced regional shares in Table 5.2.

Despite real exchange rate depreciation during the 1990s, the shares of global markets are small, except for resource-seeking primary sector firms, and even smaller for « other affiliates », implying very few efficiency-seeking firms have entered. Some firms in materials processing, trade and hospitality (which includes tourism) and infrastructure entered to supply global markets, but only in consumer goods and IT have global sales risen significantly since entry.

The distribution of sales is very uneven, but sales-weighted data confirm this picture. By turnover, half the affiliates are small (turnover less than $10 million in 2000) and account for only 4% of aggregate turnover of post-1990 foreign investors. This group re-directed sales most from domestic to regional markets. In contrast, 25 large firms (15% of the sample) had sales above $75 million in 2000, contributing 77% of aggregate turnover. Nine, including five mining companies, are large exporters, selling on average 55% of their turnover outside Africa, and contributing 80% of all affiliates' exports beyond the region. Only two of the nine – in automotive components and industrial chemicals – export significant shares to related affiliates.

Table 5.3
Domestic Market Share (%)

	Market share Entry	Market share 2000
Greenfield	12	19
Acquisition	34	35
Joint-Venture	31	33
Partial Acquisition	25	37
All firms	26	30

Source: LBS/EDGE survey.

Two-thirds of entries involved linkage with an existing South African firm, generally with already substantial market share (Table 5.3, column 1). The post-entry market share increase for both greenfields and partial acquisitions suggests the competitive advantage of foreign firms.

By raising market share, firms offset the effects of slow market growth. The mean market share rose after entry overall and in seven of nine sectors, with particularly large gains in infrastructure and in trade and hospitality. In manufacturing, where market growth was slowest, more firms were dissatisfied with their post-entry returns, even though their market shares increased and they felt they had

widened the gap with domestic firms in efficiency and quality. In services, foreign investors felt that local firms had improved their competitiveness, particularly in the IT sector, but strong sectoral growth meant that they were more satisfied than in manufacturing.

5. Sectoral analysis

Low integration into global production chains and networks is something of a puzzle, given relatively advanced levels of industrial development together with large pools of unemployed, unskilled labour. Sectoral analysis provides further insights.

(i) Autos

Global producers at the apex of this producer-led commodity chain have integrated both their local assembly operations and parts of the local component industry into their global production systems. [29] Established from the 1930s on the basis of the white domestic market and high tariffs, by the 1980s the industry was high-cost and low-volume, dependent on technology-intensive component imports but uncompetitive internationally, with foreign firms also facing political pressures.

A sectoral industrial policy from 1996 encouraged a phased transition from completely knocked down (CKD) assembly to full manufacturing, aiming to raise volumes and local component production. The carrot of increased exports to offset duties on imported components and vehicles was complemented by the stick of competitive pressure from lowered tariffs (Black, 2001). Led by the German assemblers, the major manufacturers have (re-) purchased

29. Since most of the *assemblers* were in South Africa prior to 1990, they were not included in the LBS/EDGE survey.

equity stakes in their licensed operations, linked them into global supply processes, and encouraged their global suppliers to invest in South Africa via contracts to export into global assembler networks.

Vehicle exports grew ten-fold in volume terms between 1992 and 2002, and some components (leather car-seats, catalytic converters) even faster, though component exports are narrow in scope, reflecting materials processing and resource beneficiation rather than complex manufacturing operations. The component sub-sector is divided between mainly foreign-owned export-oriented firms, and low volume, low local content firms supplying the domestic market. Many of the latter have been unable to adjust and have contracted, while those that have become export-oriented operate either in the aftermarket or as second-tier original equipment suppliers. Local operations acquired by foreign firms have done best.

(ii) Garments

Like autos, the garment industry developed behind high protective barriers for both garments and textiles. From the 1970s, apartheid-motivated subsidies assisted decentralisation from metropolitan centres to rural areas in an attempt to restrict urbanisation of black people. Taiwanese and local firms used the subsidies to compensate for very low productivity rather than adapting existing urban 'manufacturing systems' where wages were higher, and where production fed mainly into domestic retailers' 'buyer-led chains'.

Lower trade barriers and import competition in the 1990s has led to further decentralisation to peri-urban sites or neighbouring countries with low wages and poor enforcement of regulations.[30]

30. Wages in decentralised areas of South Africa are generally 25 to 50 percent of urban levels and frequently lower than in neighbouring states such as Lesotho.

Encouraged by growing exports – linked to currency depreciation, lower textile input tariffs and AGOA-linked access to the US market – FDI began to increase in 2000. But the scale of both FDI and exports remain small, with exports only about 20% of domestic output. The export market is highly segmented: domestic firms around Cape Town export mass-market woven products using domestic fabrics to the EU to complement their production of higher-end goods for domestic retail-led chains, while Asian-owned firms in the peri-urban low-wage areas supply US retailers with low-end knitted garments using imported fabric. The latter group has grown during the 1990s: the EU's share of clothing exports dropped from about 60% to about 20%, while the US increased from below 10% to 60%.

High income inequality in the domestic market contributed to the emergence of powerful retail chains. Local manufacturers have partly been unable to adapt to low wage, low skill exports, because their links with domestic retailers involved costly overhead structures (management and technical capabilities) to enable frequent style and fabric changes ill-suited to mass export markets. But they have also been unwilling to switch to export markets from domestic buyer-led chains because the latter provided a « comfort zone » of stable demand, with exports merely a « vent for surplus ».

In contrast, foreign (especially Asian) producers brought a 'portable business model' developed in the context of the Multi-Fibre Agreement which was adapted to low skill levels and enables high-volume production despite low specialisation (Gibbon, 2002). Their pre-existing networks give access to foreign, especially US, buyers and allow exploitation of opportunities such as AGOA. But

FDI alone is unlikely to significantly expand clothing exports and employment, which will require local firms to adapt to expand their activities.

(iii) Financial services

Because services are produced and consumed simultaneously, internationalisation has required « market-seeking » FDI to establish a commercial presence. During the 1990s, large business services multinationals responded to competitive pressures by offering corporate clients « global service networks » – package deals of diversified products and broad geographical spread – so that FDI was « market-sustaining », rather than simply seeking new markets. With around 1500 foreign companies active as investors or with representative offices, this was a strong motive for foreign bank entry into South Africa after 1994. The financial services market was attractive for other reasons also : the JSE was the 14th largest stock exchange globally, creating both trading opportunities and research needs, as South African securities were included in most emerging market portfolios; many of the JSE's 638 listed companies were planning international expansion and would need offshore financial services; and an expected wave of privatisation and black economic empowerment deals offered investment and merchant banking work.

When entry into the financial system was allowed in 1995, nearly 40 foreign institutions entered banking and securities trading while others upgraded from agencies. Foreign bank operations were regulated to protect the « big 5 » domestic commercial banks, who controlled around 80 percent of the market but faced competition

from non-bank retailers. Domestic stockbrokers were given little protection, and security trading is now dominated by foreign firms. Foreign entry has contributed to South Africa's integration into global financial networks, increasing cross-border financial transactions. But the major domestic banks have been able to protect their position in the face of foreign entry – though all the second-tier domestic banks disappeared as competition intensified, most foreign banks have withdrawn or cut their presence substantially, with only the very largest global banks retaining large local operations to sustain global networks.

Bank operating costs in South Africa turned out to be high, due to the regulatory requirement to maintain a local balance sheet, the country risk premium on externally-raised money, increased demand for financial sector skilled labour as well as high operating expenses in South Africa, which are partly caused by financial sector depth, ironically an attraction for foreign banks. In addition to receiving regulatory support, the domestic banks were able to move into foreign markets and compete with foreign banks for South African-linked business, servicing South African firms and offshore trading in South African assets. They were helped by the global financial market downturn linked to the dotcom bubble bursting and then '9/11', which jeopardised low-profit operations of many second-tier global banks in small overtraded markets like South Africa's.

The three sectoral analyses suggest that foreign investors are contributing to the « globalisation of production » in South African manufacturing through establishing exporting operations, but it remains limited in scale (clothing) or scope (autos). Existing South African manufacturers have been unable or unwilling to move away

from existing structures of production and consumption towards exports unless acquired by foreign firms, and there is little evidence that new domestic firms have emerged to exploit market opportunities. In services, especially business services, firms have internationalised more readily beyond Africa than in manufacturing, but again the scale is limited, at least in relation to services with no South African link.

6. The labour market impact of FDI

FDI from new investors has not contributed significantly to gross employment creation, but may be worsening the skills bias and growing inequality in the labour market.

i) Skills shortages

A common view is that growth in South Africa faces a binding skills constraint, which would be expected to discourage FDI. But affiliates' responses to a question about the availability of suitable skilled employees[31] suggests little concern. The sample mean across all four job categories – executive and operations managers, professionals and skilled technical workers – was 3.87 in 2000 (compared with 3.84 at entry), where 4.0 means « mostly available ». In all sectors, means were above 3.0, or 'sometimes available'. Suitable executive managers are the most difficult employees to find. While greenfield entrants were generally most pessimistic at entry (though obviously sufficiently discouraged from entering), their perceptions improved substantially after exposure to the local labour market. Surprisingly, partial acquisitions, presumably with local knowledge

31. Suitable was defined in terms of both quality and price. The excess supply of semi-skilled and unskilled labour made questions about their availability redundant.

prior to entry, became more negative. Reaction to the administrative and official institutional environment was very strongly negative about immigration barriers for employees from abroad, which has been a controversial issue in South Africa [32].

(ii) Human capital accumulation

Foreign firms are a potentially important source of labour skills transfer, and training spending provides an indicator of investment in human capital (though it provides little indication of training quality or firm-specificity). Table 5.4 shows that just under one-third of firms spend below 0.5% of turnover on training, and another third between 0.5% and 2%. These levels seem low, though foreign affiliates proba-

Table 5.4

Training expenditure. Percent of affiliates in sector.

Training as % of sales	Prim	Cons	Intermed	M&E	Infra	T&H	F&B	IT	Pharma	All sectors
0 - 0.5%	20	22	33	35	21	38	33	15	0	28
0.5 - 2%	40	28	33	45	32	38	24	38	20	33
2 - 4%	20	6	19	10	5	13	12	8	60	13
4 - 8%	0	22	7	6	11	0	18	31	0	12
8 - 15%	0	22	0	3	21	0	12	0	0	8
Over 15%	20	0	7	0	11	13	0	8	20	5

Source: LBS/EDGE survey.

32. Foreign nationals entering South Africa for work reasons were subject to severe administrative obstacles and delays between 1994 and 2002. This became a major public policy concern for both domestic and foreign companies, given the consensus that skills shortages are a significant growth constraint facing South Africa. A new immigration law was adopted in 2002, which should lead to easier entry for foreign workers.

bly spend slightly more than domestic firms on training.[33] There is little correlation between firms' training expenditure and perceptions of skilled labour availability, but a strong positive correlation with parent firms' global R&D expenditure. There is also a positive correlation between human resource investment and firms' perception of their own performance, relative to their expectations at entry. There is little correlation with firm size, though the largest firms (over 1000 workers) spend less on training than smaller firms, a disturbing result in terms of skills upgrading.

(iii) Black economic empowerment (BEE)

In 1994, equity ownership and management of South African firms was almost entirely white, and the need was obvious for « black economic empowerment » (BEE). Asset transfers to black people were initially « market-driven » and financed by loans secured by future earnings. With the Johannesburg Stock Exchange collapse in 1998, lower expected future dividends meant that the financing arrangements for many BEE equity transfers by publicly-listed companies also fell apart. The resulting slowing down of BEE led to more interventionist strategies, including sectoral 'transformation charters'. Racial transformation of corporate management has also been extensive, driven by employment equity quotas and regulations.

The LBS/EDGE survey investigated BEE in the FDI context, showing that foreign entry has not been a significant vehicle for expanding BEE ownership, but affiliates have been fairly effective in promoting black participation in high skill job categories. Given BEE's recent origins, very few black-owned companies have been

33. This is based on a rough comparison with the National Enterprise Survey (Gelb, 2001).

available for acquisition: the mean sample share of BEE ownership was just 2% at entry. Seven percent of foreign firms had BEE equity above 10% [34], though in these firms (11 in number), black owners' stake averaged 41% (Table 5.5, row 1). In 2000, BEE ownership in the sample had risen to 3%, and the proportion of firms with BEE owners to 12%. Within this group, the black owners' share had dropped to 33%.[35]

Table 5.5 also shows that BEE presence in executive and skilled job categories amongst foreign investors is much more substantial than in ownership. For example, BEE executive management in foreign affiliates had risen from 5% at entry to 11% in 2000, with nearly half the affiliates (46%) having black executive managers compared with only 17% at entry. Interestingly, investors' home country appears to matter for BEE: firms from English-speaking countries have transferred

Table 5.5

Black Economic Empowerment.

	% BEE (All firms)	% firms with BEE (n=162)	% BEE (for firms with BEE)
Ownership at entry	2	7	41
Ownership in 2000	3	12	33
Exec Management at entry	5	17	29
Exec Management in 2000	11	46	25
Professionals at entry	6	26	24
Professionals in 2000	17	52	33
Ops Management at entry	14	46	30
Ops Management in 2000	28	81	34
Skilled non-Managerial Then	31	69	45
Skilled non-Managerial Now	46	91	50

Source: LBS/EDGE survey.

34. Another three percent of firms were in the midst of BEE deals at the time of the survey.

35. These results are very close to those in the National Enterprise Survey in 1999-2000 (Gelb, 2001).

ownership and executive management positions but not other high-skilled jobs, whereas East Asian firms have transferred no equity but have numerous blacks in all high-skill jobs. Small firms (fewer than 100 employees) have done far better than large firms in all the skilled job categories, including executive managers. A BEE equity stake has value in certain regulated activities, so that BEE ownership and management in JVs was high at entry. Firms worried about skilled labour availability were more likely to have a strong BEE presence in skilled occupations.

7. *Summary and conclusions*

New FDI into South Africa during the 1990s has been lower than anticipated and had limited impact on employment creation and capital inflows. There appears little hope for FDI fulfilling policymakers' objective that it drives medium-run growth through these channels. The proportion of acquisitions rather than new enterprises, and the prominence of risk mitigation strategies for « cheap exit » (outsourcing production or service provision) suggest that FDI's growth impact should be sought not in increased direct use of productive factors but rather in improvements in average levels of efficiency, productivity and international competitiveness, both through foreign firms' direct contribution and through spillovers to local firms and workers.

Here, the prospects are more complex. As in earlier periods, most FDI has been market-seeking, not efficiency-seeking, aside from resource-seeking mining firms. Slow economic growth in South Africa has been a major factor in the low levels of FDI over the past decade. But there are two important changes to this image of continuity. First, 'the market' defined by entering firms includes South Africa's regional

hinterland, with substantially greater long-run market growth potential than in South Africa alone. Like domestic firms, foreign investors in South Africa are increasing trade and investment elsewhere on the continent. But sustainable growth in Africa remains bedevilled by political and economic difficulties, limiting the impact of FDI in South Africa itself. Secondly, a small proportion of foreign firms in South Africa have begun to produce for global markets and production chains, though this remains nascent in scale and scope, again if primary commodities are excluded. There is little spillover (as yet) to local firms, at least in manufacturing, except via direct links – acquisitions or joint ventures – nor evidence that new local firms are emerging to undertake export activities. This reinforces the idea that dynamic gains from FDI accrue over the long-term, at least in economies with an established industrial base.

Finally, FDI has contributed to skills upgrading, particularly amongst high-skilled blacks, particularly important in South Africa currently. But it may have also contributed to the skills twist in the labour market, through its impact on labour demand patterns and salary structures, especially in the services sectors.

These conclusions do not provide a simple 'recipe' for policymakers, but that is not to be regretted, since growth and development are complex and multi-dimensional taking a wide range of different forms over time and space, rather than a process which can rely on a single type of engine in all conditions.

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Chapter 6. Foreign Direct Investment in Morocco

Jamal Bouoiyour [36]

1. Introduction

Many developing countries now actively solicit foreign investment, offering income tax holidays, import duty exemptions and subsidies to foreign firms, as well as measures like market preferences, infrastructures and sometimes even monopoly rights. The reason for subsidising these firms is the positive spillovers from transferring technology to domestic firms. In fact, foreign direct investment (hereinafter FDI) not only plays an important part in creating jobs but is also viewed as a source of income. Yet the strong argument in favour of public support for FDI is based on the prospect for knowledge spillovers. Indeed, FDI offers an opportunity to obtain foreign capital without assuming the debt-related risk. Despite the controversies surrounding the benefits and cost of FDI, a number of developing countries' governments have now changed their policies from restricting to promoting foreign investment.

Annual flows of FDI now exceed USD 700 billion and the total stock exceeds USD 6 billion. Over the past decade, FDI flows have

36. Contact : CATT, Université de Pau et des Pays de l'Adour, Avenue du Doyen Poplawski, F - 64000 Pau. Email : jamal.bouoiyour@univ-pau.fr

grown at least twice as fast as trade (Meyer, 2003). Moreover, FDI is geared primarily to developed countries and secondarily to a few developing countries (the so-called emerging countries). In 1968 for example, 31% of FDI went to developing countries. In 1983, the OECD estimated that two-thirds of FDI had been invested in industrialised countries. In 1988-89, the developing countries' share was a mere 17% (Bouoiyour and Hattab-Christman, 1994). During the periods 1980-1989 and 1990-1998, FDI to Sub-Saharan Africa grew by 59%, to East Asia and Pacific by 942% and to Latin America by 455% (World Bank, 2000). In 2001 and 2002, the developing countries' share was 25.4% and 24.9%, respectively (UNCTAD, 2003).

As a case study, Morocco is interesting for two reasons. First, Morocco has been one of the preferred targets of FDI in the MENA (Middle East and North African) countries [37]. It should be noted, however, that the MENA countries are not popular FDI destinations : in 2002 for example, FDI inflows totalled a scant 0.34 of GDP, the lowest such figure for any region in the developing world [38].

Second, Morocco's experience is especially useful in drawing inferences for other less developed countries. The country is viewed as a good « pupil » by the World Bank and the IMF. The aim of this paper is to examine the trends for FDI flows to Morocco and to explore the determining factors and their impact on the Moroccan economy.

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37. The MENA countries are Algeria, Egypt, Iran, Israel, Jordan, Morocco, Oman, Syria, Tunisia and Turkey.

38. Sub-Saharan Africa (SSA), which is often regarded as one of the poorest regions in the world, has attracted more FDI than the MENA region during the past decade; 2.19% of GDP in 2002 (Onyeiwu, 2003).

2. The Development of Foreign Direct Investment in Morocco

Before proceeding further, it could be of interest to go through the FDI series used in this paper. Hence in Table 6.1, we present the average value of the FDI inflows received by Morocco from 1960 to 2001. Similarly, Table 6.1 reports the ratios of total FDI inflow to Gross Domestic Product (GDP) and Gross Fixed Capital Formation (GFCF). GDP's share of gross FDI inflows has grown from an average of 0.34% during the 1960s and 0.61% in the 1970s, to 0.67% in 1980s, reaching 2.17% in the 1990s. In 2001, this ratio skyrocketed to 8.64%. If we look at FDI's average share of GFCF, the trends look even more impressive: 2.84 during the sixties, 3.06 during the seventies, 3.19 in the eighties and 9.72 in the nineties. In 2000 and 2001, the ratio of GFCF to FDI was 14.66 and 38.09, respectively.

Table 6.1

FDI trends for 1960 – 2001 (in USD million)

	1960-1969*	1970-1979*	1980-1989*	1990-1999*	2000	2001
FDI	8.46	52.87	112.90	715.46	1172.36	2915.16
%GDP	0.34	0.61	0.67	2.17	3.52	8.64
%GFCF	2.84	3.06	3.19	9.72	14.66	38.09
%EU	-	-	34	68	70	80

Source: CD-ROM IMF 2004 for GDP, exchange rate (Dirham/USD) and GFCF, IMF (2004), Office de Change and Banque du Maroc for data on FDI. * Average for the decade.

Moreover, the sector-based distribution of FDI shows that until recently (1996), manufacturing industries occupied the first rank (27 % between 1983 and 1996). Construction came in second with 20%, followed by the financial sector with 12 %, while tourism was ranked 4th with 7 % for the same period. Between 1996 and 1998, the financial sector experienced buoyant growth, but manufacturing industries remained in first place. The last three years have seen a telecommunications boom with the privatization of the sector. In 2001 for example, telecommunications accounted for more than 84% of the total, whereas manufacturing occupied second place with 8%. Trade came in third with 3%.

As regards the origin of FDI, Europe in general and France in particular occupy first place. The EU's share rose from 34 % of total FDI in the 80s to 68 % in the 90s. This ascendancy of European FDI is a new phenomenon, contrary to what can be noticed for foreign trade. The Arabic countries (Saudi Arabia and United Arab Emirates) have seen their share stagnate.

3. Institutional Context

With regard to the policies adopted by the different Moroccan governments, it is important to mention that the first major step came in 1973, when the government passed the « Moroccanisation » decree restricting foreign ownership of certain industrial, commercial, and services activities to 49 %. The main purpose of this policy was political rather than economic - to reduce the dominant role of French firms in the Moroccan economy. Activities falling under the « Moroccanisation » law included textiles, clothing, footwear, leather products, travel goods, toys, fish canning

and preserving, fertilisers, edible oils, vegetables fibres and processed fruit and vegetables. The negative impact of this law on foreign investment is evident from the fact that even enterprises not subjected to the law voluntarily handed over their capital share to their Moroccan partners.

The exceptional growth of FDI inflows in the nineties can be explained by the first positive effect of the Structural Adjustment Program (SAP) adopted in 1983 under the aegis of the IMF and the World Bank and by the adoption of new policies as regards trade and foreign investment.

Thus, it was the adjustment plan of 1983 - and the accompanying complementary measures relating to a more open and flexible economy - that ushered in a radical change in Moroccan's strategy of economic development. Indeed, since 1983, the Moroccan strategy as regards foreign investment has been characterised by a relative clarification of choices which has been materialised by the adoption of incentives and measures to attract foreign investment. One such measure was the promulgation of a new code of investments in 1983. This instrument allowed full foreign ownership of Moroccan companies in certain sectors (especially manufacturing), eased restrictions on the repatriation of capital and dividends, and introduced fiscal and other incentives for FDI. The code guaranteed (i) foreign investment against the risks of nationalisation and expropriation ; (ii) unlimited transfer of dividends and profits to foreign investors; and (iii) the repatriation of foreign investors' capital and related capital gains. The investment code was further liberalised in 1988, administrative procedures governing the approval of FDI were simplified and rules similar to

those granted to non-resident foreigners were extended to non-resident Moroccans (Haddad and Harrison, 1993). The 1983 code was replaced in 1995 by a single document called the « Investment Charter ». Adopted in October 1995, this instrument replaces the complex eight-part framework of the 1983 Investment Code (except for the agricultural sector). This single text determines the fundamental aims of the State's action for the ten years to come with a view to the development and the promotion of investments through the improvement of investment conditions, an increase in the number of tax breaks and the introduction of investment incentives. The legislative and regulatory texts necessary for the achievement of these aims were presented in the 1996 Finance Law. Moreover, a privatization programme was launched in 1989 and stepped up in 1993.

In December 1989, the Moroccanisation Decree of 1973 was eliminated for all sectors. However, limits on the share of foreign participation continued to apply in a few sectors outside of manufacturing. In 1993, Dirham convertibility was introduced for routine operations, and in 1996 Morocco signed a partnership agreement with the European Union (free trade area). In 2002, Moroccan authorities established one-stop investment centres (« guichet unique » or regional investment centers, CRI) were established by Moroccan authorities. This initiative is very important because it takes 13 permits to open a business in Morocco (as compared with 10 in India and 3 in Thailand for example). The average number of days it takes to start a business is 57 in Morocco (30 in China and Thailand) [35].

35. World Bank (2002)

In response to this policy change, FDI inflows - insignificant in the 1970s - began to increase steadily in 1985-86 (see table 6.1).

In short, we can see that :

i) The implementation of the SAP yielded interesting results with regard to the inflow of FDI.

ii) With the policy of economic openness and stabilization, the amount of FDI has increased tremendously and its nature have changed with the growing power of the telecommunications and banking sectors.

ii) The EU's increasingly dominant role with regard to FDI viewed from the perspective of the creation of the free trade area.

4. The Determining Factors of Foreign Direct Investment

In his paper on « the determining factors of foreign direct investment in Morocco », Bouoiyour (2003a.) provides evidence that the intense and growing inflow of FDI to the Moroccan economy has constituted one of the defining features of Moroccan economic development in recent years. This flow of capital in the form of direct investment has picked up since Morocco's adjustment plan was implemented or more precisely since the results of this plan began to be felt from 1985 onwards.

In fact, the main regression results indicate that, in respect to the hypothesis of the neo-classical model, FDI is explained by the differences in relative factor endowments (labour costs) and to a lesser degree by the variables suggested in the more recent theories, namely human capital. This latter variable is significant but its coefficient is low in comparison to labour costs. Human capital is an essential factor in the location strategies of multinational firms that

have chosen Morocco to invest. These results confirm the ones published by the World Bank (FACS). The World Bank survey ranks skilled labour third (after low labours cost and the proximity of European markets) with regard to criteria leading foreign investors to opt for Morocco.

The late nineties were marked by an exceptional increase in FDI inflows. Indeed, FDI has reached the symbolic threshold of $3 billion, largely due to the privatization of Maroc Telecom. Other privatisations had preceded this one, notably those of the SAMIR and SCP refineries as well as the sale of the second GSM license in 1999. Thank to these privatisations but also to loan note conversions, FDI has literally exploded in recent years. However, if we look at FDI inflows without privatization, we find modest sums (less than USD 500 million in average in the last ten years). This observation shows that the Moroccan economy must continue with the reforms.

It is true that Morocco has entered a new era of economic liberalisation but also an era of controlled inflation, budget deficits, exchange rate fluctuations, etc.

During the 1970s, the Moroccan government expanded growth via heavy public spending, financed through foreign borrowing and rising receipts from phosphate exports. This culminated in a major payment crisis in 1983. The eighties were marked by a slowdown in GDP growth (3.8 % on average for the decade). As a result, the government introduced outward-oriented structural adjustment measures designed to eliminate the bias against exports, liberalised imports, and enhanced the allocative role of the financial sector.

The recovery process for public finances that was initiated in 1983 has yielded noteworthy results: in particular, the government deficit did not exceed 3% of GDP in 1992. In 2003, Morocco returned to the capital markets. A loan – allotted to finance debt repurchasing – has been subscribed in very favourable conditions. This is the result of the stabilisation policy which has led to a healthy economic situation. Active debt management efforts have proved successful and Morocco is now able to meet its obligations without difficulty. Morocco has acquired so much credibility that international lenders no longer require any guarantees. Morocco's improved credit rating confirms the international organisations' positive view of the situation of the Moroccan economy.

The foreign exchange policy has also been successful despite the caution shown by the Moroccan authorities [39].

In conclusion, it would appear that the strategy adopted by the Moroccan authorities has proved its worth, leading to a high level of investment and a reduction of the deficit and indebtedness.

All in all, these observations concerning the improvement of the economic environment, the exchange rate, inflation, and so on have been confirmed by Bouoiyour (2003a). Indeed, he finds that the variable inflation is significant, with the expected sign. This result suggests that macroeconomic stability is an important

39. By the end of the 90s, the real exchange rate had appreciated significantly in relation to the EU15 countries, leading to a corresponding decrease in the competitiveness of the exposed sectors. The lack of competitiveness of Moroccan products should have compelled authorities to devalue the currency several years ago. Instead, they preferred to concentrate their efforts on consolidating the financial system and lightening the debt burden. It was not until April 2001 that the authorities devalued de facto the value of the DH by 5 %. In fact, they modified the weighting of the various currencies which compose the basket by giving greater importance to the Euro to the detriment of the US dollar, so as to reflect better Morocco's ties to the Euro zone.

determinant of the inflow of investments. The ratio of national investment to GDP has a positive effect on GDP, i.e. foreign and domestic investments are complementary. The exchange rate is also significant, as a depreciation of the real exchange rate in relation to the currency of the investing country increases FDI inflows.

The democratisation process is following its course and the results will not be long in coming. FDI inflows can only accelerate and help the country to develop. In this respect, Morocco can set a good example for other North African countries or for developing countries in general. Besides, Morocco is considered to be a good « pupil » by the international finance bodies (World Bank and IMF).

The creation of the Europe-Mediterranean Free Trade Area offers an opportunity to develop business co-operation, but does not suffice to ensure that Morocco's exports remain competitive on EU markets characterised by growing competition

Moreover, very important obstacles remain that hinder the development process :

- Economic growth is uneven and remains very dependent on rainfall even though this dependency tended to diminish at the end of the nineties and the beginning of 2000. During the nineties, growth was under 3% in average. This poor showing is due to the importance of the agricultural sector (16% of GDP) and to its inability to respond to climate-related shocks (because of the low proportion of irrigated farmland – a scant 14% – and because of farms' small size and lack of equipment) which have become more and more frequent. This weak growth is also due to the size of the agricultural population, which is as large as the urban population.

The main consequence of this is that any fall in agricultural income has repercussions on global demand.

- Education is also a very serious problem which jeopardises the future of the country. It is true that Morocco has at its disposal a skilled and cheap labour force in certain sectors, but the educational level of the population as a whole remains low (50% of the Moroccans are illiterate).

Three strategic sectors (Textile and Clothing Products, Electronic Equipment and Chemical Products) have been identified by the Moroccan authorities, the European Union and World Bank (FACS- *Firm Analysis and Competitive Survey*) as offering real potential in terms of competitiveness, export growth and FDI inflows. However, as the World Bank pointed out in 2002, the problem in Morocco is that, at the current exchange rate, wages are too high for textiles to compete. Neither the workforce nor the firms have the skills to be competitive in these three strategic sectors or the like [40].

Moroccan firms have always pursued a strategy consisting to rely on low tech, low quality and low skills in a protected market. With liberalisation and openness, the country has to move to higher value-added/skill-intensive and high-wage industries. In other words, the quality of the labour force must be moved up.

5. FDI and Spillovers

By the 1990s, Moroccan manufacturing – like the economy as a whole – was doing poorly, in sharp contrast to what was happening with Morocco's rivals, such as Tunisia, China or Thailand. Not very long ago Morocco was richer than China. Today, real income in China

40. As regards the firms in the Moroccan sample, the World Bank (2002) indicates that less than 10% export, indicating their lack of competitiveness.

is about one-seventh higher than in Morocco (World Bank, 2002). Moroccan industry accounted for 30 per cent of GDP in 2000, a proportion that has not changed for a long time. Moreover, the industrial sector is represented by the mining industry, energy, manufacturing, construction and civil engineering. Processing (or manufacturing) industries represent a small share (18 per cent in 2000) of overall production on account of phosphate's domination. Even though the manufacturing industries represented more than 84 per cent of total exports in 1998, Morocco's competitiveness in this very labour-intensive sector remains weak. In the textile sector – clothes for example – Morocco's productivity is the same as China's and hardly higher than India's. However [41], wages in the Moroccan firms were twice as high as in China and four times as high as in India in 2000 (World Bank, 2002).

To analyse the effect of the foreign presence on the Moroccan firms, we have used data for the period 1987-1996 (18 sectors) compiled from the Moroccan Ministry of Trade and Industry database (see appendix).

A comparative analysis of the economic performances of the Moroccan and foreign industrial firms yields very interesting results. Indeed, we have calculated four ratios which characterize the sector-based performances of Moroccan and foreign industrial firms. The first ratio concerns the labour productivity (LP) of foreign firms in relation to the labour productivity of the Moroccan firms. The LP is given by total added value per worker. The second ratio concerns the average wage of the foreign firms in relation to the average wage of the Moroccan firms (AW), *i.e.* personnel costs

41 The cost of the labour force (ratio of average income in relation to average added value) is 0.40 in Morocco as compared with 0.23 in China, 0.21 in India and 0.30 in Thailand.

Table 6.2

Labour productivity, Average wage, Exports of Foreign and Moroccan firms, and Technology gap (1987-1996)

	Labour Productivity (LP)	Average Wage (AW)	Exports (Xport)	Technology Gap (TG)
Total industry	1.7*	1.6*	7.26*	3.7*

* significant at 5%. They are the performance ratios expressed by LP, AW, Xport and TG. LP (AW, Xport) is foreign firms labour productivity (average wage, exports) divided by Moroccan firms labour productivity (average wage, exports). TG is the technology gap between foreign firms and Moroccan firms.

Source: Moroccan Ministry of Trade and Industry database and Bouoiyour (2003b, 2003c).

divided by the number of workers. The third ratio concerns exports divided by the added value of the foreign firms in relation to that of the Moroccan firms (Xport). We have also calculated the technology gap as defined by Wang and Blömstrom (1992), i.e. the ratio of TFP between the foreign firms and their Moroccan counterparts (TG) [42].

As expected, the crucial premise of this kind of study is that MNCs are more technologically advanced than domestic firms. Table 6.2 gives preliminary findings from our data and indicates the existence of statistically significant differences between the labour productivity of foreign and domestic firms. The former are, on average for the ten years analysed (1987-1996), 1.7 times more productive than the latter [43].

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Table 6.2 reports that during the period under view, the wages paid by foreign firms were 1.6 times higher on average than the wages paid by the domestic firms. During the same period, exports were 7.26 times higher for the foreign firms.

Table 6.2 also highlights the technology gap. For the whole

42. Thus if the LP ratio is superior to 1, it would mean the foreign firms are more productive than the Moroccan firms (in terms of labour productivity). Just as if Export ratio is superior to 1, it would mean that the foreign firms export more than the Moroccan firms. Last but not least, if the average wage is superior to 1, it shows that the average wage distributed by the foreign firms is superior to that distributed by the Moroccan firms.

43. In the case of Portugal for example, this result becomes 2.13 (between 1996 and 1998). See Proença *et al* (2000).

industries, this ratio stands at 3.7. In other words, the foreign firms are 3.7 times more technologically advanced than the Moroccan firms. These results confirm those for labour productivity. These foreign firms are more productive (in terms of labour productivity and TFP), more geared to the outside world and paid higher wages than Moroccan firms.

Bouoiyour (2003b) examines the relationship between foreign presence and labour productivity in the Moroccan manufacturing industries. He confirms that the MNCs' presence can impact positively on the productivity of the host country. However, this relationship is a complex one and depends on absorptive capacity or the technology gap. In fact, spillover diffusion increases or stabilises with the gap. However, when the technology gap becomes high, the coefficient of spillovers decreases. The occurrence of positive spillovers is not clear because they do not increase linearly with the foreign presence. Consequently, the technology gap seems to be a condition for spillovers, but only within a certain range.

These results are in line with the idea that the benefits of the MNCs' presence do not affect host country firms equally. Bouoiyour (2000c) finds that spillovers only occur in low-tech sectors [44]. In high-tech sectors, the foreign presence decreases indigenous labour productivity, thereby confirming that the foreign presence does not affect local productivity equally in all industries.

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44. To obtain the high-technology group, we aggregate the OECD's medium- and high-tech sectors. Then, High-technology sectors are Machinery and Equipment, Transport Materials, Electric and Electronic Equipment, Office Machines and Precision Equipment, Chemical and Parachemical Products, Rubber and Plastic and Other Industrial Product. Low-technology sectors are Food Products, Other Food Products, Beverage and Tobacco, Textile Products, Clothing (except shoes), Leather and Shoes, Wood Products, Paper and Printing, Mineral Products, Basic Metal and Metallic Products. See appendix.

6. Conclusion

From a policy perspective, this is a potentially important result. Significant sums of public money are spent on attracting FDI. It is often taken as a given in the literature that FDI and foreign presence stimulate indigenous productivity and foster the economic development of the host country. Notwithstanding, this linkage is very complex and depends on the technological capabilities gap.

Instead, it is crucial that policy-makers and managers focus on the circumstances that influence the extent of spillovers and attract more FDI. These can be specific conditions, including characteristics of investors, local firms, human capital and the policy framework. Policy-makers must bridge the distance (in term of productivity) between foreign and domestic firms to create a positive spillovers. The government can oblige that foreign investors to help domestic firms to achieve real technology transfers and increase learning ability. In fact, foreign investors let such spillovers depend on their opportunity costs of sharing the knowledge and the transaction costs of establishing barriers to knowledge flows [45]. The current question of determining the « optimal » policies that the government can implement to attract FDI and extend spillovers is to be answered, because the impact of MNCs on host economies is not well understood.

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45. The case of STMicroelectronics (ST) is very interesting. In fact, ST is the largest foreign employer in Morocco and currently employs some 4,900 people in its three factories in the Casablanca region. In the process, it has developed one of the world's most advanced automated semiconductor assembly plants. In 2003, ST inaugurated its new IC design and software development centre in Rabat. Initially, the Rabat plant will focus on IC design for digital consumer applications, in particular digital TV, DVD players, flat-screen displays and digital still and video cameras and the development of customer application software. The scope of the centre's activities will be extended over time to include the development of embedded systems and broad applications, with the aim of establishing expertise in this field in Morocco. ST is confident that the emerging generation of Morocco engineers can make an important contribution to the development of state-of-the-art silicon chips, and that plants will employ 150 designers by the end of 2004.

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Appendix
Nomenclature of Economic activities

Low technology sectors	10	Food Products
	11	Other Food products
	12	Beverage and Tabacco
	13	Textile Products
	14	Clothing (except shoes)
	15	Leather and Shoes
	16	Wood Products
	17	Paper and Printing
	18	Mineral Products
	19	Basic Metal
	20	Metallic Products
High technology sectors	21	Machinery and Equipment
	22	Transport Materials
	23	Electric and Electronic Equipment
	24	Office Machines and Precision Equipment
	25	Chemical and Parachemical Products
	26	Rubber and Plastic
	27	Other Industrial Products

Comments

by Françoise Nicolas
IFRI

The paper by J. Bouoiyour addresses a very important issue for the Mediterranean economies as a group, and for Morocco in particular, namely the role of foreign direct investment (FDI) in the development of these economies. By contrast, to a number of emerging economies, in East Asia as well as in Latin America, the countries of the Southern shore of the Mediterranean basin (hereafter the MED countries) seem to have missed the FDI boom and performed rather poorly over the past decades. Recent growth performance in MED countries has been disappointing when compared both with the results of the 60s and the 70s and with the performances observed in other emerging economies. To the extent that FDI and growth are positively correlated, it may be tempting to conclude that the MED economies should do everything they can to attract FDI inflows if their objective is to raise their growth rate. It is thus worth examining in greater details the reasons for this state of affairs and the means to reverse the trend.

The paper starts with an account of Morocco's experience with FDI, emphasizing the role of the institutional context in the evolution of FDI inflows, and highlighting the major determinants of these flows (namely that they are primarily driven by differences in labor costs). The paper also stresses the importance of the privatization move towards the end of the 1990s. The final section turns to

the analysis of the impact of FDI on Moroccan firms' performances, stressing the role of the technological gap for the emergence of positive spillovers.

The paper is largely based on former research work and the technical details of the empirical analysis are not fully spelled out. As a result, little can be said about the validity and robustness of the results. Moreover, the paper concentrates primarily on results, but little is derived from these results in terms of policy implications. For all these reasons, this paper qualifies very much as work in progress. The bulk of the following comments will thus concentrate first on suggesting possible avenues for further research and second on deriving policy implications from the preliminary results obtained as well as from the existing literature on the subject.

As far as further research is concerned, two directions seem particularly promising. First, the paper suggests that the impact of foreign presence may vary across sectors, according in particular to the size of the technological gap. This conclusion is in line with the results obtained in other papers and points to the need to conduct a sectoral analysis.

It is also suggested that privatization has been a major driver for FDI inflows since the late nineties. This observation would certainly require some further investigation. The form of FDI (whether it is privatization-led or not) can indeed be expected to matter and to give rise to differentiated impacts both in terms of investment level and of productivity spillovers.

The results obtained from such complementary investigations will help determine whether FDI targeting and privatization enhancement should be set as policy priorities.

Additional policy implications

Since the 70s there has been a major change in the way FDI is perceived by developing countries. While skepticism prevailed in the past, the positive aspects have been gradually thought to clearly outweigh the negative impacts and FDI has been increasingly deemed to be a catalyst for output growth, (through) capital accumulation, and technological progress. Yet, the experience of some Latin American countries, where FDI largely dominated other forms of capital inflows in the 90s without triggering a virtuous circle of economic growth [42], demonstrates that FDI should not be thought to be a panacea and a less sanguine assessment is currently the rule.

In conventional neo-classical growth theory, long-run growth can only result from technological progress and/or labor force growth, which are both exogenous. In such models, FDI may increase the volume of investment and/or its efficiency, and lead to long-term level effects and medium-term transitional increases in growth (Nair-Reichert and Weinhold, 2000).

By contrast, new growth theory assumes that some mechanisms prevent the unbounded decline in the marginal physical product of capital. It thus provides a convenient framework to analyze the relationship between FDI and growth, because many of the growth promoting factors (human capital, externalities, etc.) highlighted by the new theory are supposed to characterize FDI (Balasubramanyam *et al.,* 1999). Thanks to positive externalities, FDI may lead to increasing returns in domestic production, but it may also be a source of human capital augmentation and technological change. According to Romer (1993) for instance, FDI has considerable potential to

42. See Fernandes-Arias and Hausmann (2000).

transfer ideas from industrial to developing countries and hence to increase productivity in the latter (World Bank, 2001). As a result, many countries strive to attract FDI hoping that knowledge brought by multinationals will spill over to domestic industries and increase their productivity. Morocco is no exception in this respect but this policy option should be evaluated with utmost care as will be shown below.

There are different channels through which positive externalities associated with FDI can occur :

i) competition channel: increased competition leads to increased productivity, efficiency and investment in human and/or physical capital, and also increased competition may lead to changes in the industrial structure towards more competitiveness and more export-oriented activities;

ii) training channel : increased training of labor and management;

iii) linkages channel : foreign investment is often accompanied by technology transfer; such transfers may take place through transactions with foreign firms;

iv) demonstration channel: domestic firms imitate the more advanced technologies used by foreign firms.[43]

However, the literature has also listed a number of reasons for more skeptical views on the linkages between FDI and growth. Moran (1999) argues that FDI may have a negative impact on the host country's growth rate because MNCs tend to operate in imperfectly competitive sectors (with high barriers to entry or a high degree of concentration). As a result, FDI may crowd out domestic

43. These four categories are taken from Hermes and Lensink (1999).

savings and investment. Moreover, FDI may have a negative impact on the external balance because profit repatriation will tend to affect the capital account negatively. Other critics argue that FDI is often associated with enclave investment, sweat-shop employment, income inequality and high external dependency. These arguments are not related to growth performances however. If production based on FDI is geared for the internal domestic consumption as opposed to exports, the current account may be adversely affected and host governments may lose control of production (Durham, 2000).

All the qualifications regarding the potential positive impact of FDI on growth point to the importance of enabling conditions: in the absence of certain conditions, the negative effects may outweigh the positive impacts.

As emphasized by numerous scholars, the nexus between FDI and economic growth in host countries is empirically neither self-evident nor straightforward (Balasubramamnyam *et al.,* 1999; Nunnenkamp, 2001), and certain conditions have to be met for the positive impact of FDI to materialize. By way of illustration, increased efficiency may be associated with a high level of financial development. Alfaro *et al.* (2001) develop a theoretical model showing for instance that improvements in local financial markets increase output by increasing the marginal product of FDI.

Individual country and industry-specific (microeconomic) studies give contrasted results. Some of them provide evidence of positive impacts of FDI on growth (Blomström and Kokko, 1996 ; Blomström *et al.*, 1999; Mody and Wang, 1997) or of positive productivity spillovers from FDI taking place through contacts between foreign affiliates and their local suppliers in upstream sectors (Smarzynska Javorcik,

2004). While others provide opposite results (Aitken and Harrison, 1999; Haddad and Harrison, 1993). Economy-wide level (or aggregate) empirical studies, based on cross-country regressions, also find mixed evidence. A number of studies find a positive impact of FDI inflows on growth for rather large samples of developing countries (Blomström *et al.,* 1992; Balasubramanyam *et al.*, 1999; Bosworth and Collins, 1999), others point to the opposite direction (Borensztein *et al.,* 1998 ; Hermes and Lensink, 1999), while a third group come to rather mixed conclusions (Nunnenkamp, 2000 ; Alfaro *et al.*, 2001).

These mixed results may be due to « technical » or methodological problems, such as the treatment of endogeneity bias, but also to sampling differences.[46] Yet, there are also good reasons to believe that the link between FDI and growth is dependent on country-specific characteristics and that it may differ from period to period. The importance of country-specific effects is suggested by case studies as well as by analyses such as de Mello (1999), Fry (1993), or Nunnenkamp (2000). FDI is found to have a positive impact on growth in some regions, while such is not the case in the control group including other developing economies. In the same vein, Nair-Reichert and Weinhold (2000) stress that the efficacy of FDI in raising future growth rates is highly heterogeneous across countries.

Going beyond the possible existence of regional specificities, a number of recent studies have tried to identify the reasons for the

46. As emphasized by Nunnenkamp (2000), the type and form of FDI (greenfield vs M&A) may also play a role: as the motivations for FDI flows vary, they may give rise to different impacts. Similarly, the orientation of FDI may matter if FDI is not channelled to the sectors and economic activities that are essential in the development and growth process of the host economy, the associated negative effects may well outweigh the positive ones (Dabour, 2000).

differentiated impacts of FDI on growth. The contribution of FDI can make certainly hinges on the circumstances in the recipient countries. More generally, the positive relationship between private capital inflows and investment (and thus growth) depends on a country's absorptive capacity (World Bank 2001). This capacity may depend on a number of factors, it encompasses not just the macroeconomic policy framework, but also political stability, the health (and depth) of the financial system, the educational attainment of the work force, the orientation of the trade régime, the quality of physical infrastructure, the efficiency of government services and the degree of corruption. There may be a threshold level of these various factors below which foreign investment has no significant effect.

In conclusion, FDI seems indeed to be a relevant factor in enhancing a country's growth performance, but for the positive impact to take place certain host country's preconditions are necessary. Those particular preconditions should be mostly pursued in order to generate a self reinforcing mechanism between FDI and growth.

These remarks lead to the conclusion that FDI-specific policies are not necessarily the most effective nor the most efficient measures, and that FDI policies should not be envisaged in isolation but as part of a wider array of policies.

Since absorptive capacity is thought to be key (as is actually implied in the paper), the recommendation to the Moroccan Government is to do its utmost to enhance this capacity, rather than to target FDI. In other words, the Moroccan Government should definitely concentrate its efforts on improving the domestic environment (in terms of human capital, financial development, macroeconomic stability, etc).

Finally, attracting more FDI should not necessarily be the objective while creating the appropriate conditions for FDI to trigger spillovers should definitely top the list of priorities.

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Chapter 7.
FDI in the Tunisian Textile and Clothing Industry

by Jean-Raphaël Chaponnière,
CNRS, CEPN (Paris XIII)

and Serge Perrin
Research Department, AFD

1. Introduction

Textiles play a very significant role in the Tunisian economy where they are currently nicknamed the « 50% sector » : half of manufacturing employment, of manufacturing exports and of FDI affiliates [47]. While Tunisia shares this textile and clothing (T&C) trade and industrial specialisation with several developing countries, the role played by foreign affiliates in this sector is rather unusual as the most common form of offshore production has been through outsourcing, contracting out production, and not by setting up production subsidiaries.

Foreign direct investment (FDI) inflows into the Tunisian textile industry have been a strong asset for this sector as its exports have

47. This short note is based on a forthcoming study by the authors, entitled " Le textile habillement tunisien et le défi de la libéralisation. Quel rôle pour l'investissement direct étranger ? ", Agence Française de Développement, Paris. We thank API, CETTEX, FIPA and IEQ for their cooperation.

increased very rapidly over the last 20 years. Tunisia stands as the fifth largest apparel exporter to the EU market and the second largest in France and Italy. However, such reliance on foreign firms' exports could also prove to be a source of fragility in an industry that stands on the threshold of a new era with the phasing-out of the Agreement on Textiles and Clothing (ATC) in 2005. Furthermore, tariff reductions under the EU Association Agreement is likely to lead to increased competition for Tunisian firms. This chapter examines FDI's contribution to the Tunisian textile and clothing industry. It argues that policy – *i.e.* the creation of an offshore regime - played a major role in building Tunisia's first export sector, but has not succeeded in moving up the T&C value chain and in generating linkages with the rest of the economy.

2. T&C in developing countries and Tunisia's specialisation

Many developing countries have entered the manufacturing sector via the clothing industry, as the latter uses relatively simple technologies for the production of basic items (Amsden, 2001; Bairoch, 1997) . Indeed, since the introduction of the sewing machine by Singer in 1852, this sector has not witnessed a real technical breakthrough. Automation has been quite limited with the exception of cutting machines and knitting machines. The most important changes have concerned assembly work organisation with the generalisation of « just in time ». While the garment branch has remained a labour-intensive industry, the textile industry has been transformed by the introduction of new equipment and the creation of new products. Spinning and weaving have become capital-intensive industries and are characterised by economies of scale.

Textiles and clothing are closely linked : textiles are the main input for clothing and clothing is the main market for textiles. These strong input-output relationships justify the notion of the « textile chain » that has been often been used to describe the textile and clothing industry.

The different operations along the textile chain, from fibre production to spinning, weaving and clothing production, can be easily carried out in different places. As these products are light, transport costs are not a real issue. However, the duration of transport does represent an obstacle as it increases the level of work in progress and the cost of inventories. This segmentation can also take place within the clothing industry. Outsourcing the Cut – Make & Trim operations, which are the labour intensive segments, has been a regular practice of the industry. Outsourcing initially took place within the same country or the same city as in the garment districts in Paris, New York or Bologna. Since the 1960s, however, it has become internationalised. Garments can be cut in one country, assembled in another, finished elsewhere and sold everywhere.

The fact that the textile industry is more capital intensive than clothing does explain the international division of labour within the textile chain.

T&C and international trade

Textile and clothing trade have increased very rapidly since the 1960s. While the pace of growth of textile exports has always lagged behind that of manufactures, clothing exports outpaced manufacturing exports through the 1970s and the 1980s but witnessed a slowdown in the 1990s. According to WTO (2004), textile and clothing export flows amount to USD 320 billion (respectively USD 135

billion for garments and 185 billion for clothing) as compared with USD 720 billion for the telecommunications or automotive sectors which are, in terms of production, much more important than textiles and clothing.

Developing countries are the largest exporters of clothing and their share of world exports (excluding intra-EU trade) increased from 49% in the sixties to 85% in 2003. Their share of textile exports worldwide (excluding intra-EU trade) is 59%.

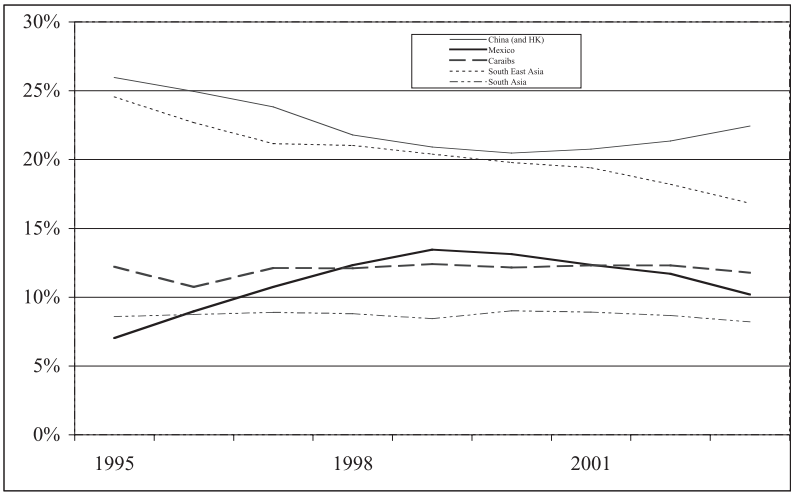
The geography of international trade in clothing is the result of several conflicting trends.

The first trend relates to the relocation of production from high-wage countries to low-wage countries. It accounts for the rapid emergence of Asian NICs' exports in the early 1960s, that was followed by ASEAN exports in the 1970s and subsequently by China, which now ranks as the world's largest exporter. This shift to Asia has been slowed down by the agreements that have constrained Asian exports since the 1950s. The first agreements were targeted at cotton product exports and were extended to all fibre products exports through the Multifiber Arrangement (MFA) which was replaced by the Agreement on Textiles and Clothing (ATC) in 1995. Under this new agreement, all quotas are to be removed by 2005 and during the 10-year transition period, the remaining quotas have also been enlarged. Countries such as China that have been facing more restrictive quotas will see their competitive position improve while countries that were quota-free (like Tunisia) may find it difficult to maintain their current market share.

The second trend has been the proliferation of clothing suppliers in countries where production costs were somewhat higher than in

Asia. The emergence of these new exporters has been a direct consequence of privileged customs arrangements and preferential trade agreement. Starting in the sixties, US clothing manufacturers used a provision of the US tariff code that encouraged outsourcing to invest in the maquiladoras at the Mexican border; later, the Caribbean Basin Initiative gave preferential access to the US market to Caribbean exports (Gereffi *et al.,* 2002). In the nineties,

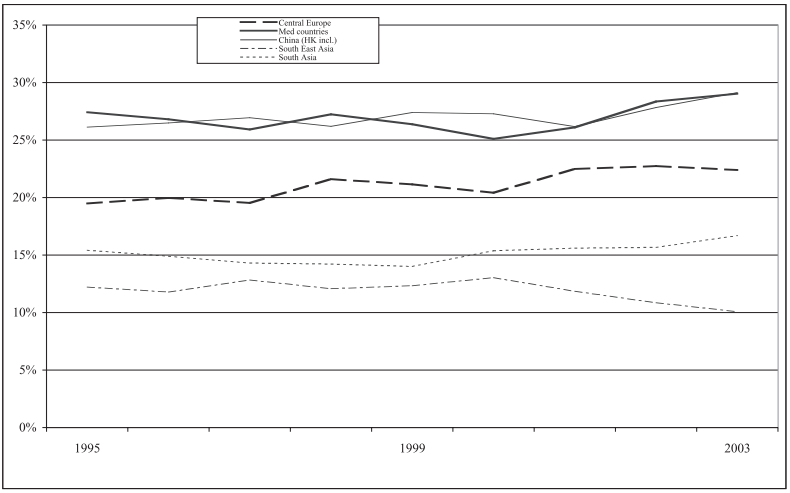
Figure 7.1
US clothing imports (1995 to 2003)



Source: WTO (2004).

NAFTA gave further impetus to Mexican exports; subsequently, the African Growth and Opportunity Act (AGOA) boosted African clothing exports while several other bilateral treaties (Vietnam, Jordan Free Trade Agreement, etc.) have increased other countries' exports.

Figure 7.2
EU clothing imports (1993 – 2003)



Source: WTO (2004).

The EU devised a similar customs arrangement ("perfectionnement passif") in order to facilitate outsourcing. It signed preferential trade agreements with Mediterranean countries in the seventies, with Eastern Europe in the nineties as well as other multilateral (ACP in the sixties) and bilateral agreements with LDCs (Bangladesh and the Everything But Arms Initiative).

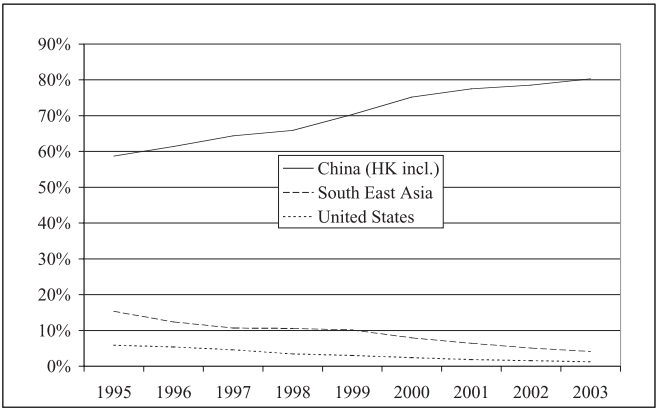
These trade agreements have given market access for new exporters and, as a consequence, there are two main types of exporters among emerging countries :

(i) Global players that are competitive on all markets, such as the Asian NICs in the sixties and seventies, which have now been replaced by China and India. China is the largest clothing exporter to the US, the EU and Japan, and Chinese products have made inroads in a large number of developing countries. India is respectively sixth and seventh on the EU and US markets. Even if it has been constrained by the MFA, China's share of world clothing markets have steadily increased over the years. Once China joined the WTO in January 2002 it received the same advantages as other members as it has benefited from the lifting of 11 quotas. By 2003, China's market share in these categories had increased from 11 to 45% on the EU market and had reached 60% on the US market.

(ii) Regional players that are competitive in their core market. On these markets (either US or EU), they have been able to displace the global player but they do not export on the other core market. This is the case of Honduras (and the other Caribbean countries), which is the third largest exporter to the US and does not export to Europe. It is also the case of Romania and Tunisia, which are, respectively, third and fifth on the EU market, and do not export to the US. In most of these

countries, the textile industry has lagged behind the clothing industry and clothing exports are made of imported fabrics. There are some exceptions like Mauritius and Vietnam that enjoy preferential treatment by the US and by Europe. The other exception is Turkey, whose textile industry is very competitive. Turkey is the second largest clothing exporter to the EU and has made inroads into the US market.

Figure 7.3
Japan's clothing imports (1995-2003)



Source: WTO (2004).

As a consequence of the proliferation of regional agreements, the level of concentration of US and EU clothing imports is quite low : the largest 10 exporters account for respectively 52% (US) and 72% (EU) of total imports. This stands in sharp contrast with the concentration ratio on the Japanese import market. On this quota-free large market, China's share was 86% in 2003, followed by the EU (8%) and Korea (1%).

This contrast is an important wake-up call before the ATC ends. It illustrates the challenge facing regional exporters in South America as well as in Northern Africa as the 2005 deadline nears. Although more than half of the clothing trade has been liberalised, the remaining quotas cover some of the products that are Tunisia's biggest export items. This measure could therefore have a devastating impact on Tunisia's clothing exports and economy.

Tunisia's clothing specialisation

Clothing specialisation in Tunisia (53% of its manufacturing exports) can be compared to Bangladesh (76%), Mauritius (83%), Honduras (71%) or Morocco (40%), all countries characterised by a lower level of per capita income. The intensity of clothing exports in Tunisia appears to be rather high as compared to countries with similar levels of per capita income. Whereas in many countries, T&C trade specialisation is diminishing, this is not the case with Tunisia, where it has increased during the 1990s.

The industry plays a key role in the Tunisian economy. It produces 7% of GDP and T&C employment (around 200 000 people) accounts for some 40% of total manufacturing sector employment. Over the past 20 years, the number of manufacturing units has grown to over

2000, with the average T&C firm employing 100 workers. Woven garments represent over 74% of T&C Tunisian exports compared to 19% for knitwear and 7% for textile. Exports increased at a double-digit rate up to 2000. Over the last four years, the rate of growth has slackened: measured in Euros, it contracted in 2003 and during the first four months of 2004, as Tunisia's share of the European market fell slightly.

Most of Tunisian clothing exports rely on imported textiles. According to the WTO, Tunisian imported USD 1.5 billion worth of textiles and exported over USD 3 billion of clothing in 2003. Its textile trade balance has increased over the years. Tunisian has a small textile industry. Its largest enterprise has been taken over by a foreign group and exports denim fabrics. The volume and quality of textile production do not meet the requirements of the export-oriented garment industry.

Globalisation of T&C has been trade-related as outsourcing has taken the form of contracting out garment production to local firms. There have hardly been any instances of FDI in the clothing industry in the case of the Asian NICs, although there are some foreign affiliates of Asian NICs' clothing firms in the ASEAN countries.

One can illustrate the difference by looking at the relative share of T&C in FDI and exports : over the last four years T&C has accounted for 12% of emerging countries' exports, and during the same period, 5% of FDI flows to emerging countries were related to T&C. This difference can be explained by the fact that T&C is not a capital-intensive activity (and thus has little weight in FDI statistics). But it is also due to the fact that a foreign affiliate does not enjoy a clear competitive advantage over a local producer. The competitive advantage of a foreign affiliate lies not in the production process but in product design and market knowledge.

3. The prominent role of FDI in textiles & clothing

FDI flows to Tunisia have been stable over the past ten years, representing about 2.7% of GDP [48]. The country stands rather favourably in comparison to other MENA economies, attracting relatively more FDI (as a percentage of GDP) during the 1997-2001 period than Egypt (1.1%) and Lebanon (1.4%), but less than Morocco (3.6%). In terms of stocks, the share of FDI as a percentage of GDP is 66% in 2003, more than twice the average for developing economies (31%) or Morocco (26%) (UNCTAD, 2004). Aside from geographic proximity to the EU market, Tunisia enjoys a favourable macroeconomic environment (sustained growth of 5%, low inflation and low budget deficit) and a relatively skilled labour force. The government has also established an attractive investment regime as a key component of its strategy to promote exports and growth.

A unified investment code introduced in 1994 allows foreign investors to hold up to 100 percent of equity without prior authorisation in most sectors, although some restrictions apply in agriculture, commerce and services. All investment projects are entitled to a package of common incentives [49], and additional incentives are granted according to economic priorities (exports, regional development, agriculture, environmental protection, technology transfers). The most important specific incentives in manufacturing apply to export promotion and

48. However the average annual inflow doubled compared to the 1985-1995 period, from 0.26 USD billion to 0.52 USD billion. FDI figures were boosted in 1998 and 2000 by the privatization of cement and chemical companies, which accounted for half of total inflows these two years.

49. With the exception of mining, energy, and finance. The package of incentives includes: tax exemption of 35% on income earned and reinvested in Tunisia; suspension of VAT on capital goods produced locally; reduction of custom duties up to 10% on imported equipment having no similar equipment manufactured in Tunisia. For more information on the Investment Code, see the Tunisian Industry Promotion Agency (API) website.

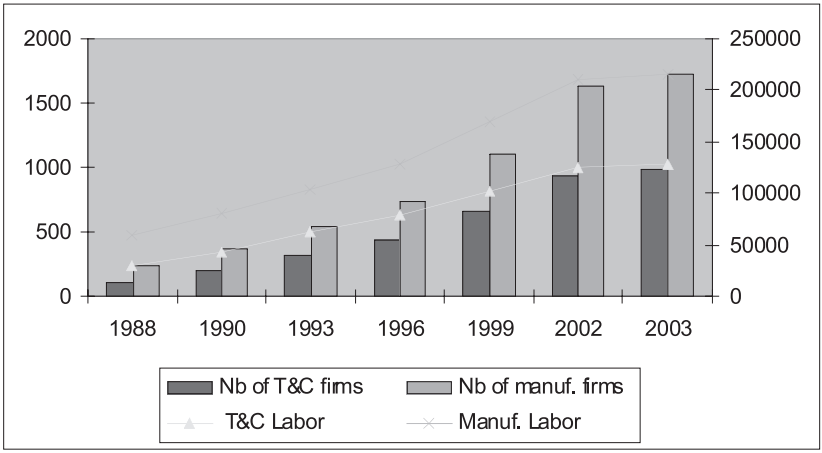
concern notably fully-exporting enterprises (*i.e.* exporting at least 80% percent of production). According to the Foreign Investment Promotion Agency (FIPA), nearly 85% of the foreign manufacturing enterprises established in Tunisia re-export all their production to other markets. They enjoy full exemption from income tax for the first ten years of activity with a 50% reduction in income tax thereafter, and duty-free import of capital goods that have no local equivalents. These fully-exporting enterprises are de facto granted offshore status, but are allowed to set up their plant anywhere in Tunisia, unlike free trade zones [50]. These advantages have held to develop a competitive export sector, notably in textiles & clothing, where foreign-invested enterprises represent a sizeable share of domestic investment and employment.

FDI and domestic investment

Tunisia's growth has been driven more by public than private investment, and despite overall good macroeconomic fundamentals and favourable investment legislation, private investment shows little sign of dynamism. According to Tunisian Central Bank data, average private investment stood at 13.2% of GDP in the 1996-2001 period, up slightly from 12.3% over 1992-1995. By contrast, during the 1990s, the private investment ratio in five high-growth countries (Korea, Chile, Malaysia, Mauritius, Thailand) was 25% (Casero and Varoudakis, 2004). Private investment accounted for just 52% of total investment, below the target of 56% assigned in the IXth Development Plan (1997-2001). Greater private investment is a key precondition for accelerated growth, thereby explaining the recent drive by Tunisian authorities to attract more foreign investment.

50. There are also two free trade zones in the country: Bizerte (60 km north of Tunis) and Zarzis (450 km south of Tunis).

Figure 7.4
Foreign-invested enterprises in manufacturing and T&C (number of enterprises and employment)



Source : Industry Promotion Agency (API). Only firms with more than 10 people are considered here.

FDI's contribution to domestic investment has increased over the past ten years, from 15% to 20%. In some sectors, such as textiles and electronics, the ratio stands at 40%, reflecting the importance of FDI for these activities. Despite their prominence, FDI flows in T&C are on a declining trend - from 93 million dinars in 2000 to 32 million dinars in 2003 -, which coincides with the decrease of domestic investment. However, according to API (Industry Promotion Agency), the number of T&C foreign-invested enterprises was on the rise as of 2003 (987 out of 1725 in all manufacturing, see Figure 7.4).

FDI and exports

The creation of the offshore regime gave the export sector a boost, with T&C accounting for a majority of offshore trade (58% of exports in 2003, see table 7.1). Exports from textile enterprises in the general regime are insignificant and the trade balance is negative, whereas even if offshore enterprises' imports are large, the trade balance remains positive. The contribution of offshore T&C to the industrial trade balance (69%) is even higher than its share of industrial exports [51]. Tunisia is structurally highly dependent on EU markets, which absorb 95% of the country's textile exports, and this trade is heavily concentrated in two countries (France and Italy account for about two-thirds of textile exports).

FDI and employment

In line with its strategy of « equitable development », securing job creation has been a central objective of Tunisia in promoting FDI and the offshore regime. As of 2003, there were more than

51. Nearly all foreign affiliates in T&C are on the offshore regime, but it was not possible to separate their specific contribution to trade from Tunisian offshore firms.

Table 7.1

Contribution of offshore enterprises to trade

Billions of Euros, 2003	Textile & Clothing	Manufacturing	Share of T&C
Exports	2.84	6.90	
General regime	0.06	2.12	
Offshore	2.77	4.78	58%
Imports	1.96	9.36	
General regime	0.18	6.02	
Offshore	1.79	3.34	54%
Trade balance	0.87	-2.46	
General regime	-0.11	-3.90	
Off shore	0.99	1.44	69%

Source : CEPEX (Export Promotion Center).

2,600 foreign affiliates employing 232,000 people in Tunisia. In T&C alone, foreign affiliates account for more than 60% of total employment in this sector (and nearly half of all firms employing 10 persons or more). This figure is likely to be higher if we could estimate indirect employment through temporary or more permanent links with local subcontractors. In a context of persistent high unemployment (15%), there is a real concern that foreign investors may relocate their plants to Eastern Europe or Asia, and this explains the generous tax incentives offered to those who invest in the offshore regime.

Regional development and the role of incentives

The Investment Code grants advantages for investments in regional development areas ("encouragement zones" and priority zones). These investments are eligible for an investment grant of 7% of the project cost, State participation in the infrastructure expenses and five years full payment of the employer's contribution to social security schemes (15.5% of the payroll). They are also fully exempt from income tax for the first ten years of activity and benefit from a 50% reduction on income tax for an additional ten years. Did these incentives influence siting decisions of foreign and Tunisian textile firms in the country ? According to Cettex data (see table 7.2), only 9% of T&C enterprises are located in regional development zones, and a majority (60%) are located in four regions (Monastir, Nabeul,

Table 7.2
Location of T&C enterprises, by region

Region	Non resident	Resident	Total
	%	%	%
Monastir	27.2	24.8	25.7
Nabeul	15.8	7.5	11.0
Sfax	2.9	16.2	10.9
Sousse	13.9	8.1	10.6
Tunis	7.5	10.1	8.9
Ben-Arous	6.8	6.2	6.2
Bizerte	7.1	5.0	6.0
Ariana	4.0	5.1	4.6
Manouba	3.3	4.6	4.0
Autres	11.5	12.4	12.1

Source : adapted from Cettex (Technical Textile Center) database.

Sfax, Sousse). This policy do not seem (as yet) to have succeeded in promoting a more balanced regional development in a significant manner. Financial incentives are unlikely to compensate for the extra costs of finding skilled labour and quality infrastructure in deprived regions, but from a policy perspective, it may nevertheless be a second best choice for keeping the regional gap from widening.

This raises in general the issue of the efficiency of investment incentives focusing exclusively on specific sectors or firms. Most studies tend to question their efficiency in raising national welfare (Blomström and Kokko, 2003), mainly because the beneficial effects of FDI (*e.g.* spillovers of foreign technology) are not automatic and depend on a complex set of factors. According to one estimate [52], the annual average cost of incentives in Tunisia was around 20% of private investment over the 1994-1999 period. Tax incentives are the main source of advantages (80%) granted. Although it is legitimate to assess the cost of incentives, one cannot conclude whether these incentives are « too costly » to attract FDI, for at least two reasons : first, as this rough estimate does not disentangle the benefits received specifically by foreign investors, it would be irrelevant to compare the annual cost of incentives to inward FDI flows ; second, the cost should be put in perspective by a comparison with the various benefits in terms of contribution to employment, exports, domestic investment, technology transfer and so on, which are by nature difficult to quantify. The central issue is whether Tunisia would have attracted this large volume of FDI had it not

52. *Pour un nouveau palier de l'investissement privé*, Commission préparatoire de la conférence nationale sur la relance de l'investissement privé et la création des entreprises, juillet 2000, Tunis (PrepCom for the National Conference on Relaunching Private Investment and Company Start-ups, July 2000, Tunis).

been for these incentives. According to our interviews with some twenty T&C enterprises, it appeared clearly that tax incentives were a key motivation to invest and remain in Tunisia.

The main upshot of the offshore regime is that it has led to a « dual economy », a source of distortions between a export-oriented sector under a preferential tax status and a onshore sector facing more complex administrative procedures. The two regimes will be harmonised by 2007 and the specific advantages of the offshore regime will gradually be phased out.

4. Conclusion

Foreign direct investment can play an important role in building a country's export success, as Tunisia's textile and clothing experience demonstrates. The large presence of foreign investors in this sector is rather unusual, as the most common form of globalisation of T&C is more trade-related (through outsourcing) than FDI-related. Foreign-invested enterprises account for a prominent share of the sector's investment, exports and employment. Apart from solid macroeconomic fundamentals, attractive labour costs and geographic proximity to the EU, generous incentives and the promotion of an offshore regime for over thirty years have been a strong « pull » factor for foreign investors. This « model » relied mainly on outward processing trade with the EU, i.e. European enterprises exporting fabrics and re-importing them as fully-processed clothes to the originating country. This strategy may have proven to be successful until the 90s, but the country should have climbed the value chain and graduated from the outward processing trade stage. Today, Tunisian T&C continue to face three sources of weakness :

- The lack of a functional textile and finishing sector. Inputs are nearly all imported and there is little prospect of increasing local sourcing due to problems of delays and low quality. This contributes to an « enclave economy » where offshore enterprises operate with few linkages to the rest of the economy. Downstream, local demand has also been neglected. Offshore enterprises may sell up to 20% of their production to the local market, but this is conditional on the government's authorisation.
- A strong focus on low value-added subcontracting work. Co-contracting – *i.e.* subcontractors sourcing fabrics on behalf of buyers - is in progress but remains limited. International buyers increasingly prefer co-contracting to subcontracting and may shift to countries capable of providing this service.
- Overly strong dependence of garment exports to EU markets (notably France and Italy).

This suggests that FDI alone cannot help Tunisia move up the T&C value chain if the country does not provide the right incentives to invest in developing its supply chain, and in design and marketing skills. Also, more structural reforms are needed to modernise the industry, for example in the banking and financial sector. Upgrading from subcontracting to co-contracting requires six times more working capital, which is the main obstacle for small and medium-sized enterprises. It may be too late to consider that FDI can facilitate a move up the value chain. However, thought could be given to a more « hands-on » approach to targeting prospective greenfield investments in the textile and finishing sector. The recent entry of new investors from Spain and Portugal could pave the way for others and help reduce the traditional dependence on the large EU

markets. Also, the free-trade arrangement signed with Turkey in September 2004 – which ensures accumulation of origin – is a positive signal. Tunisia may remain competitive in the near future in some medium- and high-quality niche markets if it invests more in higher value design.

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PARTICIPANTS IN THE AFD-IFRI WORKSHOP

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Contributors

Céline Azémar, Université Paris I - Panthéon-Sorbonne

Jamal Bouoiyour, Université de Pau et des Pays de l'Adour

Jean-Raphaël Chaponnière, CNRS/CEPN, Paris

Rodolphe Desbordes, Université Paris I - Panthéon-Sorbonne

Stephen Gelb, The EDGE Institute, Johannesburg

Edward M. Graham, Institute for International Economics, Washington DC

Hung Vo Nguyen, NISTPASS, Hanoi

Klaus E. Meyer, Copenhagen Business School

Oliver Morrissey, University of Nothingham

Jean-Louis Mucchielli, Université Paris I - Panthéon-Sorbonne

Serge Perrin, Agence Française de Développement

Frédérique Sachwald, Institut français des relations internationales and CEPN

Dirk Willem te Velde, Overseas Development Institute, London

Discussants

Matthieu Crozet, Université Paris I - Panthéon-Sorbonne

Françoise Lemoine, CEPII, Paris

Xiaming Liu, University of Surrey

Jean-Pierre Marcelli, Agence Française de Développement

Curt Nestor, Göteborg University

Françoise Nicolas, Institut français des relations internationales

Other participants

Saloua Ben Zaghou, Institut d'Economie Quantitative, Tunis

Roger Goudiard, Agence Française de Développement

Fabrice Hatem, Agence Française des Investissements Internationaux

Liza Jabbour, Université Paris I - Panthéon-Sorbonne

Hmida Khlifi, Institut d'Economie Quantitative, Tunis

Robert Peccoud, Agence Française de Développement

Armand Rioust de Largentaye, Agence Française de Développement

Tél : 01 53 28 03 05 - E-mail : wiltzmag@club-internet.fr
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