FOREIGN DIRECT INVESTMENT: A MEAN FOR POVERTY REDUCTION

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1. Progress in Poverty Reduction

The Millennium Declaration, signed in 2000 by 189 states, comprises eight major goals, aiming to achieve them by 2015. The first is to combat extreme hunger and poverty, defined as having an income of less than $1 a day, by halving the number of people in extreme poverty.[1] The United Nations (UN) stated in 2012 that poverty reduction will be reached before the deadline but that still about one billion people in the world will be living in 2015 on less than $1.25 per day. The biggest progress in poverty reduction was made in China, India and Southeast Asia. Significant progress could also be made in Sub Sahara Africa and Southern Asia; nonetheless, nearly half of their population is still living in extreme poverty.

The OECD states that due to conflict and violence, as well as weak institutions, fragile and conflict affected countries[2] have the lowest progress in achieving the Millennium Declaration Goals (MDGs). While around one fifth of the population of low-income countries lives in fragile states, they contribute to more than one third of the overall poor.[3] In the future, this trend will continue and the OECD expects that this share will increase to more than a half in 2015. Between 2001 and 2011 the number of the working poor declined worldwide from 26.4% to 14.8%. The progress was made due to robust growth rates and productivity gains. Nonetheless, the average productivity in developing countries is only one fifth of that of a country in the developed world.[4]

For the UN "the private sector plays a vital role in development in many countries, including through public-private partnerships and by generating employment and investment, developing new technologies and enabling sustained, inclusive and equitable economic growth."[5] First of all – to the UN – the governments are responsible for the achievement of the MDGs, but "Over the past decade, domestic and foreign companies have become more important and influential actors in many developing countries as a result of privatisation and market liberalisation and they have a growing stake in the future progress of these countries."[6] In other words, the private sector has to contribute to the MDGs through domestic and foreign direct investment (FDI).

The concepts for poverty reduction are divergent. Authors like **Sachs**[7] describe a poverty trap in which the Least Developed Countries are caught; the inhabitants of these countries are too poor to generate sufficient capital for growth and development by themselves. Hence a distinct increase of international aid is a necessity for poverty reduction. Other authors like **Easterly**[8] or **Moyo**[9] promote investment as a tool for growth and productivity enhancement.[10] For both concepts there are pros and cons; hence the discussion in literature is controversial as are the empirical findings.[11] The solution might not be

1 See United Nations (2000): UN General Assembly resolution A/RES/55/2: United Nations Millennium Declaration, http://www.un.org/millennium/ declaration/ares552e.pdf, 16.2.2013, p. 5. The reference level are the figures of 1990. In 2000 extreme poverty was defined by living from 1 $ per day. Since 2007 the amount is 1.25 $ per day.

2 For a definition of fragility see OECD (2012): Fragile States 2013: Resource flows and trends in a shifting world, Paris, p. 15.

3 See OECD (2012): Achieving the MDGs - addressing conflict, fragility and armed violence, http://www.oecd.org/international%20dialogue/achievingthemdgs-addressingconflictfragilityandarmedviolence.htm (20.12.2012).

4 See United Nations (2012): The Millennium Development Goals Report, We can end poverty 2015, New York, p. 7-9.

5 See United Nations (2010): Keeping the promise: united to achieve the Millennium Development Goals. http://www.un.org/en/mdg/summit2010/pdf/mdg%20outcome%20document.pdf p. 11 (24.2.2013).

6 Nelson, J.; Prescott D. (2003): Business and the Millennium Development Goals: A Framework for Action. London, p. 4.

7 Sachs, J.D. (2006): The End of Poverty. London.

8 Easterly, W. (2003): Can Foreign Aid Buy Growth? In: Journal of Economic Perspectives, 17,3; pp. 23-48.

9 Moyo, D. (2010). Dead Aid: Why Aid Is Not Working and How There Is a Better Way for Africa. London.

10 Bezuidenhout, H. (2009): A Regional Perspective on Aid and FDI in Southern Africa. In: International Advances in Economic Research, 15,3; p. 310-321, 311.

11 For an overview see Arndt, C.; Jones S.; Tarp F. (2009): Aid and Growth: Have We Come Full Circle? UNU-WIDER discussion paper No. 2009/5, Helsinki.

an either/or, but to look closer at the conditions that countries have to fulfil to be able to profit from FDI and thereby raise the income of poor households.

2. Foreign Direct Investments in Developing Countries

Many developing countries changed their investment policy from regulation, a trend which could be observed during the 1950s to the 1980s, to liberalization during the 1990s to early 2000. In the following years the United Nations Conference on Trade and Development (UNCTAD) observed two different kinds of political attitudes: further liberalization of investment regimes in response to intensified international competition for FDI, economic stimulus packages and state aid as well as regulation of FDI to track broader policy objectives.[12]

Since 2010, developing and transition economies absorb more than half of global FDI inflows.[13] In 2011, the pre-crisis average level of FDI flows was outnumbered, and all major economic groups had an increase of FDI, 21% for developed countries, 11% for developing countries, who reached a record of 684 billion US dollars, and 25% for transition economies. But Africa and the Least Developed Countries (LDCs) experienced for the third time a decline in FDI inflows. In Africa the decline was a result of disinvestment in North Africa, whereas inflows to Sub-Sahara-Africa recovered. The share of FDI flows to the LDCs fell from 3.1% in 2009 to 1.9% in 2011. The main investments in the LDCs are greenfield investments, with a high share to the primary sector, especially in mining, quarrying and petroleum.[14] In the majority of fragile states, FDI inflows are still marginal and the few FDIs went to selected middle income and/or resource-rich countries within the fragile states.[15]

3. Effects of Foreign Direct Investment on Poverty Reduction

Poverty reduction effects from FDI result mainly through growth, technological spillovers, human capital development and productivity gains. The standard neoclassical **Solow** type steady state growth model focuses on FDI as capital inflow which enlarges the capital stock of the host country. In the short run, FDI has a positive influence on the host country's growth rate, but in the long run due to diminishing marginal capital returns, the host economy converges to the steady state growth. Economic growth is fostered in the long-run by the exogenous variable technological progress.[16] In the endogenous growth models,[17] FDI also increases the local capital stock, but the positive influence to the growth rate in the long run is generated by technological spillover effects and local skill development. This can enhance productivity, depending on the knowledge gap between host and home country and the ability of domestic companies to absorb the spillovers. FDI can also create new jobs, which improve household income and generate government income through taxes.[18]

12 UNCTAD (2010): World Investment Report 2010: Investing in a Low Carbon Economy, New York and Geneva.

13 UNCTAD (2012): World Investment Report 2012: Towards a New Generation of Investment Policies, New York and Geneva, p. xi.

14 UNCTAD (2010): op cit., p. 75.

15 OECD (2012): Fragile States … op cit, p. 69.

16 See e.g. de Mello, L. R. (1999): Foreign direct investment-led growth. Evidence from time series and panel data, Oxford Economic Papers, no. 51, pp. 133–151, 135; Hudea, O. S.; Stancu S. (2012): Foreign Direct Investments, Technology Transfer and Economic Growth. In: Romanian Journal of Economic Forecasting no. 2, pp. 85–102, p. 85.

17 See Romer, P. (1986): Increasing returns and long run growth. In: Journal of Political Economy, 94,5, pp. 1002-1037; Romer, P. (1987): Growth based on increasing returns due to specialization. In: American Economic Review, 77,2, pp. 56-62; Lucas, R.E. (1988): On the mechanics of economic development. In: Journal of Monetary Economics, 22,1, pp. 3-42.

18 For an overview to the theoretical approaches see e.g. Harms, P.; Méon, P.-G. (2011): An FDI is an FDI is an FDI? The growth effects of greenfield investment and mergers and acquisitions in developing countries, Proceedings of the German Development Economics Conference, Berlin, No. 38, p. 2.

The empirical results about FDI and growth, as well as poverty reduction, are ambiguous.[19] **Klein** et al. conclude that FDI under competitive and balanced market conditions can upgrade productivity throughout the economy, depending on the capability of domestic companies to respond to the spillover effects. FDI in the field of extraction and sale of minerals or fuels often has not been associated with poverty reduction and growth.[20] **Mahmoud** points out governments should promote FDI in the most productive sector of a developing economy, because there the spillover effects can be absorbed. He further proposes that governments also should foster FDI in the labor-intensive and pro-poor sectors.[21]

4. Prerequisites for Foreign Direct Investments

The strategy of multinational companies (MNCs) for international integrated production systems and the globalisation of the value chain to capitalize on differentials in international labour costs lead to an increase in FDI and increased the interest to provide goods and services directly in often protected emerging markets.[22] The economic determinants of the FDI inflows for developing countries have been analysed to a desirable degree.[23] FDI is driven by three main forces: resource seeking, efficiency seeking and market seeking. Hence both economic theory and management literature focuses on the ability and quality of resources, capabilities and markets.[24]

The relative influence of the determinants changed during globalisation due to the fact that FDI in services had gained more and more importance.[25] In 1996, the UNCTAD pointed out that the relevance of the national market size decreased whereas cost differences between locations, infrastructure, skill availability and ease of doing business gained.[26] **Dunning** stated in 1999 that FDI to developing countries shifted from market and resource seeking to efficiency seeking.[27] In contrary to these statements, **Nunnenkamp** showed that market related determinants are still the dominant factor for the FDI distribution. Complementary factors of production gained momentousness and local skills are a growing "pull factor" for FDI. The tariff jumping motive lost relevance. Administrative bottlenecks remain a strong factor for discouraging FDI. His results are supported by several other empirical studies.[28]

To attract FDI, potential host countries have to fulfil several prerequisites. Developing countries already must have reached a minimum level of educational, technological and infrastructure development. Moreover, the openness of the economy, economic freedom and the quality of the political and institutional frameworks plays a major role in the global competition for FDI.[29] Literature shows also that the quality of political

19 Bezuidenhout, H. (2009): op cit., p. 311.

20 For an overview with a synopsis see Klein, M.; Aaron, C.; Hadjimichael, B. (2001): Foreign Direct Investment and Poverty Reduction. http://elibrary.worldbank.org /content/workingpaper/10.1596/1813-9450-2613.

21 Mahmoud, A. (2010): FDI, Local Financial Markets, Employment and Poverty Alleviation. http://ssrn.com/abstract=1638792 (4.7.2011), p. 27.

22 See Walsh, J.P.; Yu, J. (2010): Determinants of Foreign Direct Investment: A Sectoral and Institutional Approach, International Monetary Fund Working Paper, WK/10/187, p. 3.

23 Busse, M.; Hefeker, C. (2005): Political Risk, Institutions and Foreign Direct Investment. HWWA Discussion Paper, 315, Hamburg, p. 1.

24 Dunning, J.H.; Zhang, F. (2008): Foreign direct investment and the locational competitiveness of countries. In: Transnational Corporations, 17,3, pp. 1-30, p. 3.

25 Nunnenkamp, P. (2002): Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game? Kiel Working Paper No. 1122, p. 2.

26 UNCTAD (1996): World Investment Report 1996. United Nations, New York, p. 97.

27 See Dunning, J. H. (1999): Globalization and the Theory of MNE Activity. University of Reading, Discussion Papers, International Investment and Management 264.

28 Nunnenkamp (2002): op cit. pp. 2ff.

29 See Schneider, F.; Frey, B. S. (1985): Economic and Political Determinants of Foreign Direct Investment. In: World Development, 13, pp. 161–175; Quazi, R. (2007): Economic Freedom and Foreign Direct Investment in East Asia. In: Journal of the Asia Pacific Economy, 12,3, pp. 329-344.

institutions plays a major role in the location decision of multinational companies. In accordance with the approach from **Dunning**[30] and the institutional economics literature,[31] the quality of these institutions with dimensions like political stability, predictable regulatory changes, government predictability, guarantee of property rights, etc., influence the efficiency of the companies' environment and hence their economic success.[32] Generally multinationals prefer host countries with lower political risks and an efficient institutional environment,[33] which, according to **Dunning and Zhang** have an important influence on the extent of the inward FDI.[34] In the 1990's, international cross country studies found negative impacts of corruption[35] and institutional uncertainty.[36] These results were criticised to have been determined by unobserved factors,[37] and in the meantime, most empirical analyses are country specific.

According to the OECD, transparency has the components of regulatory transparency and information transparency. Regulatory transparency includes legislation, the regulatory control of discretion, registration and dissemination of existing and proposed regulations. Moreover, consultation with interested parties and appeal processes that are clear, predictable and consistent are included. The provision of accurate and timely statistical data, timely notification of on-going policy discussions within the government to interested parties and the general public are parts of information transparency.[38] Transparency is not only a prerequisite for all decision makers in an economy to know their own rights and obligations but, furthermore, is essential for business planning and operation.

Du, Lu and Tao analyse China and show the importance of property rights protection and the negative influence of corruption. Their findings further confirm empirical studies in literature.[39] **Seyoum and Manyak** highlight the positive and significant effect of public sector transparency on FDI inflows.[40] **Busse and Hefeker** used twelve political risk indicators to analyse their influence on FDI. They found that government stability, investment profile, law and order as well as democratic accountability of the government have the highest influence on FDI inflows. Foreign investors are highly sensitive to changes in political stability and the framework in which governments operate. Therefore, they point out that fundamental democratic rights do matter to multinationals operating in developing countries.[41] Their findings are in line with other empirical studies. Furthermore, they analysed the influence of conflicts and violence in the host country and increased economic and political instability. These factors have a negative impact on FDI, because they increase uncertainty and the risk premium of investment projects. Whereas FDIs

30 Dunning (1999): op cit.

31 See e.g. the overview in Held, M.J.; Nutzinger, H.G. (2003): Institutions interact with economic actors: plea for a general institutional economics. In: International Journal of Social Economics, 30,3, pp. 236-254; Herath, G. (2005): Analysis of the potential and problems of new institutional economics for third world development. In: International Journal of Social Economics, 32,10, pp. 877-892.

32 See Witt, M.A.; Lewin, A.Y. (2007), Outward foreign direct investment as escape response to home country institutional constraints. In: Journal of International Business Studies, 38,4, pp. 579-594.

33 See Brouthers, K.D.; Brouthers, L.E. (2000), Acquisition or greenfield start-up? Institutional, cultural and transaction cost influences. In: Strategic Management Journal, 21, pp. 89-97; Demirbag, M.; Tatoglu E.; Glaister, K.W. (2010): Institutional and transaction cost determinants of Turkish MNEs' location choice. In: International Marketing Review, 27/3, pp. 272-294, p. 277.

34 Dunning and Zhang (2008): op cit., p. 17.

35 See Wei, S.-J. (2000): Local Corruption and Global Capital Flows. In: Brooking Papers on Economic Activity, 30,2, pp. 303-354.

36 See Brunetti, A.; Kisunko, G.; Weder, B. (1998): Credibility of Rules and Economic Growth: Evidence from a Worldwide Survey of the Private Sector. In: World Bank Economic Review 12, pp. 353-384.

37 See Busse and Hefeker (2005), op cit., p. 2.

38 See OECD (2001): Flagship Report on Regulatory Quality, Paris.

39 See Du, J.; Lu, Y.; Tao, Z. (2007): Economic Institutions and FDI Location Choice: Evidence from U.S. Multinationals in China. Chinese University, Hong Kong.

40 See Seyoum, B.; Manyak, T. G. (2009): The impact of public and private sector transparency on foreign direct investment in developing countries. In: Critical perspectives on international business, 5,3, pp. 187-206.

41 See Busse and Hefeker (2005): op cit.

are not affected through the influence of the military in politics, tensions among religious groups and the degree of conflicts among ethnic groups have again negative impacts on the FDI inflow. Fragile states and developing countries with weak government have obvious disadvantages to attract FDI if they are not able to overcompensate for these disadvantages through other factors like natural resources.

5. Conclusion

FDI can accelerate the development of economies and make a contribution to poverty reduction through the positive economic effects of FDI. Generally, multinational companies prefer host countries with a stable and predictable political framework. Transparency and accountability are crucial for FDI inflows, both market and factor driven. Civil liberties and political rights are major factors MNCs take into account when operating in developing countries. Conflicts and violence, economic and political instability as well as trade sanctions have a negative impact on the FDI flow. But exactly these facts are typical for several LDCs and all fragile states. If not resource abundant, these countries are not attractive for most international investors. They still rely on international donations, despite the debate about their efficiency and effectiveness. In other developing countries FDI can make a positive contribution to poverty reduction.

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