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WHAT DO HOST COUNTRIES GAIN FROM FOREIGN DIRECT INVESTMENT INFLOW? (A REVIEW OF EMPIRICAL EVIDENCE)

The role of foreign direct investment (FDI) for host countries has been debatable since its emergence. A number of country-specific and cross-country studies have been conducted to investigate the impacts of FDI on host countries from different perspectives. A review of empirical evidence may help us to enhance our understanding of the effects of FDI in host countries and to develop a framework that may help if not for all but for most host countries in capitalizing FDI. This study reviews the empirical evidence related to FDI impacts focusing on economic growth, spillover effects from FDI, effect on balance of payment, and development of human capital in host countries. This study would help to understand which assumptions about FDI are supported by empirical evidence. Moreover, this study points to various directions for further research.

Keywords: foreign direct investment, FDI capitalizing, host countries, economic growth, spillover effects.

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ЩО КРАЇНИ-РЕЦИПІЄНТИ ОТРИМУЮТЬ ВІД ПРИПЛИВУ ПРЯМИХ ІНОЗЕМНИХ ІНВЕСТИЦІЙ? (ОГЛЯД ЕМПІРИЧНИХ ДАНИХ)

У статті показано, що роль прямих іноземних інвестицій (ПІІ) для країн-реципієнтів завжди була суперечливою. З метою вивчення впливу прямих іноземних інвестицій було проведено ряд досліджень як усередині конкретної країни, так і за даними декількох країн. Огляд емпіричних даних може допомогти покращити розуміння впливу ПІІ на країни-реципієнти і розробити модель капіталізації ПІІ у більшості країн. Проаналізовано емпіричні дані, пов'язані з ПІІ, з акцентом на економічне зростання, супутні ефекти від прямих іноземних інвестицій, вплив на платіжний баланс і розвиток людського капіталу в країнах-реципієнтах. Зазначено, які припущення про ПІІ підтверджуються емпіричними даними, представлено різні напрямки для подальших досліджень.

Ключові слова: прямі іноземні інвестиції, капіталізація ПІІ, країни-реципієнти, розвиток економіки, супутні ефекти.

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ЧТО СТРАНЫ-РЕЦИПИЕНТЫ ПОЛУЧАЮТ ОТ ПРИТОКА ПРЯМЫХ ИНОСТРАННЫХ ИНВЕСТИЦИЙ? (ОБЗОР ЭМПИРИЧЕСКИХ ДАННЫХ)

В статье показано, что роль прямых иностранных инвестиций (ПИИ) для стран-реципиентов всегда была спорной. С целью изучения воздействия прямых иностранных инвестиций был проведен ряд исследований как внутри конкретной страны, так и по данным нескольких стран. Обзор эмпирических данных может помочь улучшить понимание влияния ПИИ на страны-реципиенты и разработать модель капитализации ПИИ в большинстве стран. Проанализированы эмпирические данные, связанные с ПИИ, с

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акцентом на экономический рост, сопутствующие эффекты от прямых иностранных инвестиций, влияние на платежный баланс и развитие человеческого капитала в странах-реципиентах. Указано, какие предположения о ПИИ подтверждаются эмпирическими данными, представлены различные направления для дальнейших исследований.

Ключевые слова: прямые иностранные инвестиции, капитализация ПИИ, страны-реципиенты, развитие экономики, сопутствующие эффекты.

I. Introduction. Foreign direct investment (FDI) is not simply a source of private capital. It is considered as a package of financial resource, technological and managerial knowledge and skills, and employment. FDI is argued to be enhancing economic growth of a host country through enhancing capital and increasing exports.

The globalization trend and the removal of restrictions on FDI have encouraged the FDI flow. The FDI inflow at the global level increased by 28% from US \$558 bln in 2003 to US \$711 bln in 2004 followed by another increase from US \$711 bln in 2004 to US \$916 bln in 2005. The share percentage of developing countries in FDI also increased. The FDI stock of developing economies as percentage of gross domestic product (GDP) reached 27.0 in 2005 as compared to 9.8 in 1990 (UNCTAD, 2006).

FDI is considered superior to other private capital resources due to its long lasting prospects and multiple purposes. Compared to other capital flows (commercial banks loans, portfolio flows and official flows), FDI flows have been emerging as the largest component of net resource flows to developing countries since 1994 (UNCTAD, 2006). Reisen and Soto (2001) compared benefits of various private capital inflows and suggested that developing countries should not rely solely on national saving but also resort to FDI and portfolio equity inflows to stimulate long-terms growth.

FDI is also credited to have positive impact on human capital formation in a host country. Todo and Miyamoto (2002) incorporated R&D activities and HR development conducted by multinational enterprises (MNEs) and domestic firms. They theoretically justified that R&D activities and human resource development conducted by MNEs stimulated knowledge diffusion from MNEs to domestic firms and, hence, improved domestic productivity.

The above is one side of the picture. The other side of these views cannot be ignored. Marxist political and economic theory views MNEs as an instrument of imperialist domination. The objective of MNEs is to earn profit and repatriate it to a home country and these MNEs neither have intention to transfer technology to a host country, nor play any role in employment generation. They may threaten national sovereignty and autonomy of a host country by influencing its economic policies (Hill, 2005).

Notwithstanding these diverse arguments, the need of FDI is mounting gradually. A number of country-level and cross-country studies provided mixed findings regarding the impacts of FDI on host countries and they cannot be generalized from country to country or from region to region. Here it is noteworthy to emphasize that impact of FDI on a host country is a function of many factors such as macroeconomic environment, political stability and the FDI policy stance of a host country.

Review of empirical evidence may help us enhance our understanding of the effects of FDI in host countries and to develop a framework that may help if not for all but for most host countries in capitalizing FDI.

The intention of this study is to review empirical evidence related to FDI impacts (social and economic) on host countries and to summarize them. Moreover, this study would help to understand which assumptions about FDI are supported by empirical evidence. Summary of such empirical evidence may provide guidelines for policy makers to coin the policies in favor of a host country. It would also provide opportunities for further research by exposing multiple aspects of FDI. The rest of the study would comprise:

Section II describes how FDI influence economic growth of a host country;
Section III covers the linkages and spillover effects of FDI on domestic firms;

Section IV reviews the effect of FDI on balance of payment;

Section V encompasses effect of FDI on human capital formation;

Section VI draws the conclusions from all previous sections suggesting some recommendations.

II. FDI and Economic Growth. FDI may enhance economic growth of a host country by employing people; filling the gap between savings and investments; and by generating revenue through taxes. FDI influences not only capital formation but it also generates the revenue for government through taxes and defuses the pressure of the balance of payment (Seid, 2002).

FDI in the form of green-field is said to increase competition among producers in a host country. Currently such competition is being observed more for services, e.g., telecommunication, retailing and financial services. Under the pressure of competition, firms invest more in plant equipment and R&D in their endeavor to get advantages over rival firms. Such activity led to increased productivity, product and process innovation, and economic growth. Sometimes subsidiary of MNE might crowd out indigenous competitors due to its greater economic power and might monopolize the market. Agosin and Mayer (2000) also supported these views.

FDI do not necessarily result in new capital formation. Mexico is one of the top recipients of FDI, and 71% of such investments was meant for purchasing already existing Mexican companies in 2001 (Gazcon, as cited in Cypher & Dietz, 2004).

Haddad and Harrison (1993) rejected the hypothesis that foreign presence accelerated productivity growth of domestic firms in Morocco. Sahoo and Mathiyazhangan (2003) examined the role of FDI in economic growth of India through export promotion and found long-run relationships among GDP, FDI and export. Studying the relationship between FDI, trade and domestic output in Pakistan over the period from 1972 to 2001, Ahmad, Alam, and Butt (2004) found long-run relationship. Shahbaz, Ahmad and Chaudhary (2008) endorsed these results for Pakistan.

For transitional economies such as China, Zhang (2001) found positive effects of FDI on economy. Externality effects of FDI facilitated China's transition towards market economy. Djankov and Hoekman (2000) in Czech Republic found the factor productivity (TFP) growth rate of foreign owned firms was higher than that of local firms.

Sharma and Gani (2004) examined the impact of FDI on socioeconomic development for middle and low-income countries and found positive results with weak robustness. Sharma and Sharma (2003) structured 2 alternative econometric models to investigate the degree and the dimension of the relationship between FDI inflows and GDP on the data from 29 countries. The study empirically supported the hypothesis that FDI was related directly to development, as measured by income.

Makki and Sumwaru (2004) analyzed the role of FDI and trade in economic growth within the endogenous growth theory framework and found that FDI and trade contributed to economic growth. Tiwari and Mutascu (2011) found positive impact of FDI on economic growth in 23 Asian countries.

The study conducted by Alfaro, Chanda, Kalemli-Ozcan, and Sayek (2006) found that the same amount of increase in FDI generated 3 times more additional growth in financially well-developed host countries than in financially poorly-developed countries. Khan (2007a) endorsed such results for Pakistan.

Through FDI, MNEs play their role in industrial development by rising up the scale of operations in host countries industry upstream and downstream. Markusen and Venable (1999) endorsed such views. Borensztein, De Gregorio and Lee (1998) found that FDI has positive effect on economic growth of a host country provided that a host country has sufficient stock of human capital and absorptive capacity.

Baharumshah and Thanoon (2006) found impact of FDI on the growth process in East Asian countries. The impact of FDI was more than that of domestic investments. Sahoo (2006) found positive impact of FDI on economic growth of South Asian countries, i.e. India, Bangladesh, Sri Lanka and Nepal, except Pakistan. Lensink and Morrissey (2006) found that volatility of FDI has negative impact on growth. Moreover, evidence for positive impact of FDI on growth was not robust.

Reviewing the above evidence, it can be concluded that FDI might boost economic growth through export promotion, encouraging investment and developing linkages. This relationship can be enhanced if a host country has better human capital, developed financial market, and competitive environment.

III. FDI and spillover effects. One of the most frequently discussed aspects of FDI in literature is the spillover effect of MNCs in a host economy. It might take the form of knowledge and technology spillover. FDI is considered as a channel for transfer of technology from industrialized countries to less developed ones.

For the purpose of development, important indicator is transfer of skills and technology from TNCs. But this transfer depends on the linkages between TNCs and host economy. Though Mexico has been major recipient of FDI, yet research does not suggest that Mexico's national base has either grown, or diversified or deepened its capital and knowledge/skills level to any serious extent (Cypher, as cited in Cypher and Dietz, 2004).

FDI may improve the productivity of a host country through transfer of technology. Such views seemed to be supported by Xu (2000) in 40 countries and found that technology transfer by US MNEs contributed to productivity growth in developed countries but not in less developed countries (LDCs). To get benefits from technology transfer, the basic requirement for a host country is to have minimum human capital threshold level. However, most LDCs do not have this. Makki and Sumwaru (2004) recognized the role of FDI and trade on growth in 66 developing countries.

Yudaeva, Kozlov, Melentieva, and Ponomareva (2003) found that foreign-owned firms were more productive than local firms in Russia due to access to technology and better management. In more reform-oriented regions, firms were more productive than those of less reform-oriented regions. Positive spillover effects of technology and management practices were observed on domestic firms in the same industry but foreign firms had a negative effect on firms in vertically related industry. Poor quality of supplier damaged the vertical relationship. Smarzynska (2003) examining the firm-level data from Lithuania supported the results that positive productivity spillovers from FDI took place in upstream sectors but horizontally there was found no indication of spillovers.

Studying Chinese manufacturing firms, Liu (2008) showed that an increase in FDI lowered short-term productivity level but raised long-term productivity growth of domestic firms in the same industry. For vertical spillovers, they found backward linkages to be a statistically more important channel through which spillovers occurred.

Cheung and Lin (2004) examined the impact of FDI on innovation activities in China via spillover channels such as reverse engineering, skilled labor turnover, demonstration effects and supplier-customer relationship. They found positive spillover effect of FDI. Aitken and Harrison (1999) found no evidence in Venezuela regarding technology spillovers. Khan (2007b) also observed similar results for Pakistan during the period 1972-2005.

Blomstrom and Kokko (2003) associated the spillover effects of FDI with stock of human capital, the interest in local firms of promoting skills transfer and competitive environment. Hanson (2001) found weak evidence that FDI generates positive spillovers for host countries. Moreover, at plant level, there is little evidence that FDI raises the productivity of domestic enterprises.

Djankov and Hoekman (2000) suggested that parent firms transferred more know-how to their affiliates than joint venture firms obtained from their partners. FDI had a positive impact on all other firms in an industry. Lipsey (2002) found mixed evidence for spillovers to local firms' productivity. It seemed to depend on host country policies and environments and on technological levels of host-country firms. FDI increased exports both quantitatively and qualitatively.

Overall, however, the spillover impact of FDI showed a blurry picture. From the evidence, it might be judged that transfer of technology depends on linkages between MNEs and locally owned firms, absorptive capacity of local firms in terms of human capital level, policies of a host country, and interest shown by local firms in promoting skills.

IV. FDI effects on balance of payment. The impact of FDI on balance of payment of a host country has been unclear. One view is that FDI might affect the balance of payment positively by flowing in the initial capital, substituting imports and contributing to exports.

Capital account of a host country is positively affected by initial capital inflow. But this is one-time-only effect. FDI is considered as a substitute for imports for a host country and can help improve capital account. However, imports of input material and machinery offset the advantage of import substitution. For example, FDI by Japanese automobile companies in the United States and the United Kingdom can be

taken as substitutions for imports from Japan. But with import of various component parts from Japan, the positive impact of FDI on the current account of the US may not be as great as initially it was supposed (Hill, 2005).

If Japanese automobile companies in the United States and the UK (technologically advanced economies) could not influence exports substantially, then it is difficult to say that FDI may have positive impact on balance of payment in developing countries where all machinery, parts and input materials have to be imported.

In the framework of the neoclassical theories, FDI influenced China's manufacturing exports in terms of volume as well as in structure. During 1980-98, the volume of China's export increased from US \$ 18 bln (47% of exports as manufacturing goods) to US \$ 184 bln (89% of exports as manufacturing goods) (SSB, as cited in Zhang, 2001).

Blomstrom and Kokko (1996) reviewed the empirical evidence and concluded that MNCs could play a vital role for productivity and export growth. According to Hill (1990) and Naujoks and Schmidt (1995), foreign-owned firms tend to export a great proportion of their output than their locally owned counterparts. Sahoo (2006) recognized the positive impact of FDI on export growth through its positive spillovers from South Asian countries.

Empirical evidence suggests that positive impact of FDI on exports of host countries is more than that on imports. If a problem of balance of payment occurs, it would likely be small (WTO, 1996). Khan and Kim (1999) found that FDI worsened the balance of trade in Pakistan. TNCs might use transfer pricing techniques in response to the restrictions imposed by a host country government on repatriation of funds. This technique might be more harmful for less developed nations where tax collection system is weak. Moreover, parent companies from developed countries make loans to their subsidiaries in less-developed countries. The amortization with interest can cause a potential drain on balance of payments. Unless the subsidiary is earning foreign exchange via export or by contributing to import substitution in host country, the outflow of principal value and interest can exceed the original inflow of financial capital, thus creating a net outflow over time (Cypher and Dietz, 2004).

The arguments given in the above evidence are diverse. Both views, in favor of and against the favorable impact of FDI on balance of payment have their own weight. For developing countries specifically, the opponents of FDI seem to be heavier.

V. Effect of FDI on human capital formation. Among the advantages of FDI for host countries, the human capital enhancement has been quoted frequently by the proponents of FDI. The literature shows that the spillover of advanced technologies and skills from MNEs to domestic firms of a host country can take place through 4 routes, namely vertical linkages; horizontal linkages; labor turnover and labor spin-offs. Vertical linkages step forward when MNEs provide technical assistance and training to domestic suppliers of the intermediate goods or to the buyer of these products. Such an effect was observed for Mexican auto industry. The spillover appeared through the shop-floor training; the quality control training; weekly meetings, and technical assistance (Agosin & Mayer, 2000).

Horizontal linkages occur when domestic firms in the same industry get technical support through skill-development institutions supported by MNEs. Labor

turnover occurs when MNE trained workforce transfers know-hows to local firms after switching over to their services from MNEs to local firms. Labor spin-offs occur when employees of MNEs set up their own businesses.

The impact of FDI in terms of human capital formation is not uniform among different host countries. The transfer of technology due to FDI depends upon cooperation of government, industry, academia, and labor. Moreover, FDI will be more beneficial when it comes after developing countries have created a sufficient pool of human capital (Ritchie, 2002). Xu (2000) argued that host country should have minimum threshold of skills before the arrival of TNCs. Korea and Taiwan followed this pattern. But in Southeast Asia, MNCs came before the creation of a pool of intellectual capital.

When a host country gets a continuous flow of FDI through attracting higher value-added MNEs, it enhances skill level of preexisting MNEs and domestic enterprises. These upgraded skills further attract FDI and so it becomes a virtuous circle (Miyamoto, 2003). Government policies have been important to facilitate training, minimize financial constraints and market failures and promote MNEs to invest in human resource development (HRD) of a host economy.

Gachino (2006) examined the role of foreign presence, FDI and firm level capabilities in human capital development in 3 manufacturing industries in Kenya. Human capital development was found to be different in each of the industries. A high positive correlation was observed between FDI and human capital development. Countries technically backward like Kenya are likely to have FDI play a positive and significant role in human capital development.

Aitken and Harrison (1999) found no evidence in Venezuela that FDI increase the stock of human capital. Michie (2002) studied the impact of MNEs on human capital enhancement in developing countries. This impact appeared not to be a function of MNEs but it was found to be a result of government efforts to attract FDI by enhancing human capital. Literature has suggested that public education is the best way to enhance human capital. MNEs are not likely to provide such education.

Narula and Marin (2003) found that MNEs subsidiaries in Argentina possessed a more skilled labor force overall and spent more on training than similar domestic firms. Higher labor productivity and higher wages were observed to be prevalent in these MNEs subsidiaries. But when measured in terms of knowledge creation and utilization, little difference was found between affiliates and domestic firms. The benefit of MNE activities in Argentine economy was not reflected in domestic firms' value added growth.

According to Kapstein (2002), the theory of FDI's contribution to economic growth of emerging economies via human capital formation remained controversial due to 2 reasons. First, in most countries FDI accounted for only a small share of GNP and total employment, so its impact on national educational and economic performance was unlikely to be great. Second, FDI increased wage disparities and that factor might undermine the contribution of FDI to growth. As demander and supplier of labor, MNEs might influence educational outcomes at the market where these firms do business.

Slaughter (2002) discussed the impact of multinational affiliates on human capital development in the demand and supply framework. On the demand side, FDI

stimulates demand for skilled workforce in host countries to work with the technology transferred by MNEs. On the supply side, FDI may develop human capital through different modes. The first one is the short-term firm level at which individual firms interact with a host country workforce through on-the-job training and supporting local educational institutions in terms of curriculum choices and vocational training. The second one is the long-term country level at which MNEs jointly contribute to macroenvironment of a host country positively through raising workers' productivity, providing a relatively stable source of foreign capital and paying taxes. The rise in economic activities owing to the presence of FDI means the rise in tax revenues that may allow the government invest more in education and training. Of course, this is not a self-triggered process but the broadening of tax bases may relax budget constraints and thereby make plausible comparatively better investment in education and training.

Majority of the evidence in the above literature supports the argument that FDI and human capital mutually interact. But host country intervention and many other factors are essential and may enhance this interaction.

VI. Conclusions. FDI has been getting the position in developed as well as developing countries as a package of financial resources, technology, and skills for the last 3 decades. Despite conflicts from various aspects its importance gradually increased. The review of empirical evidence may help us enhance our understanding of the effects of FDI in host countries and to develop a framework that may help if not for all but for most of host countries in capitalizing FDI.

This study reviewed and summarized the empirical evidence related to FDI impacts on host countries in terms of economic growth, spillover effects from FDI, improvement in balance of payment, and development of human capital. Moreover, this study would help to understand which assumptions on FDI are supported by empirical evidence.

The review helps to conclude that FDI might boost economic growth through export promotion, encouraging investment and developing linkages. This relationship can be enhanced if a host country has better stock of human capital, developed financial market, and competitive environment. The spillover impact of FDI sketched a blurry picture. The transfer of technology from MNEs depends on the linkages between MNEs and locally owned firms, absorptive capacity of local firms in terms of human capital level, policies of a host country, and interest shown by local firms in promoting skills. The arguments regarding the impact of FDI on balance of payment are diverse. Both views, in favor of and against this impact have their own weight. For developing countries specifically, the opponents seem to be heavier. The argument that FDI and human capital mutually interact got sufficient support. But host country intervention and many other factors are essential to enhance this interaction.

Summary of such empirical evidence may provide guidelines for policy makers to coin the policies in favor of host countries. Governments of host countries should intervene for maximizing benefits from FDI and minimizing negative effects like capital outflow, transfer pricing, and crowding out effects. These objectives can be achieved if government of a host country is able to control the monopoly of MNEs; restrict the outflow of capital; persuade MNEs to take input from local contents and export certain percentage of manufacturing; open export oriented sectors for FDI;

develop linkages between MNEs and host country firms; and encourage MNEs for training of employees and enhancing suppliers' performance.

As the topic of FDI is multifaceted so are its fields for further research. Different policies, macroeconomic environment, endowment of resources and competitiveness of a country encourage us to conduct studies empirically at regional and country level. Sector, firm and plant level data may enhance our insight about spillover effects regarding technology transfer, and training and development of human resources.

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