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Foreign Direct Investment and Corporate Codes of Conduct in National Development Strategies: Costs, Benefits and Policy Options

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ABSTRACT

In an era of stagnant or declining aid budgets, foreign direct investment offers significant scope for channelling much-needed resources to developing countries. However, a number of caveats must be borne in mind. FDI does not always lead to economic growth, and whether it does so depends critically on the local economic environment. FDI is also very geographically concentrated, meaning that most developing countries still require greatly increased aid flows to alleviate poverty, to build infrastructure and to develop sound institutions. Moreover, the FDI that is available has costs as well as benefits. Some studies have shown that up to a third of projects can be a net cost to the host country. Major FDI proposals should therefore be evaluated carefully in a comprehensive cost-benefit framework. This is a much-neglected, but essential skill and most developing countries require increased technical assistance and resources to build their capacities to undertake it. Neglecting sound cost-benefit analysis of FDI is a dangerous false economy. Corporate codes of conduct should be discussed in this context. Their utility is highly dependent on what they include, what they leave out and what procedures are in place for monitoring and enforcing them. Many fail on all counts. The better ones can be useful as an adjunct to a sound legal environment, or as a restraint in more chaotic circumstances, but they must not 'crowd out' the development of sound, well-enforced social, environmental, tax, anti-corruption and labour laws. Moreover, a company's adherence to an outstanding code of conduct does not automatically mean that its FDI will be beneficial to the host country. FDI by the perfect company in the wrong sector or in the wrong economic circumstances can still result in a net cost to the host country. Thorough cost-benefit analyses of proposed FDI projects remain essential.

1. Introduction

In March 2002 the UN will host a major international conference on Financing for Development in Monterrey, Mexico. The conference has been called for a variety of reasons, not the least of which is the recognition of a crisis today in development funding for developing countries.

In May 1996 at its 34th High Level Meeting, the OECD's Development Assistance Committee (DAC) adopted a number of International Development Goals, which included:¹

1. Reducing the proportion of people living in extreme poverty in developing countries by at least 50% by 2015.

2. Substantial progress in primary education, gender equality, basic health care and family planning, including:

a) Universal primary education in all countries by 2015.

b) Eliminating gender disparity in primary and secondary education by 2005.

c) Reducing the death rate for infants and children under the age of five years in each developing country by two-thirds of the 1990 level by 2015, and reducing the rate of maternal mortality by three-fourths during this same period.

d) Making access available through the primary health-care system to reproductive health services for all individuals of appropriate ages, including safe and reliable family planning methods, as soon as possible and no later than the year 2015.

3. Current national strategies for sustainable development, in the process of implementation, in every country by 2005, so as to ensure that current trends in the loss of environmental resources - forests, fisheries, fresh water, climate, soils, biodiversity, stratospheric ozone, the accumulation of hazardous substances and other major indicators - are effectively reversed at both global and national levels by 2015.

At that time, the average level of official development assistance (ODA) given by OECD countries was 0.3% of their combined GNP. In 1999, when the targets already seemed unreachable, the level of ODA had fallen to 0.24%. This figure is actually slightly higher than that for 1997, when it reached an all-time low of 0.22%. In fact from 1992 to 1997 total DAC members' ODA fell by 21% in real terms. Only *four* OECD countries consistently give above or equal to the UN target of 0.7% of GNP: Denmark, Norway, the Netherlands and Sweden.²

In this context of relatively stagnant support for ODA, and concerns over the volatility of portfolio investment in the wake of the Asian financial crisis, many look to an increased role for foreign direct investment (FDI) as a way of boosting finance for development. Along with trade liberalisation, the imperative for developing countries to entice more FDI has become a mantra emanating from major international institutions such as the World Bank, IMF, WTO and OECD, as well as most governments.

The Report of the High-Level Panel on Financing for Development, popularly known as the Zedillo Report, after its chair, former Mexican President, Ernesto Zedillo, explicitly recommends that developing countries "should create an attractive environment for foreign investment, especially FDI".³ In itself, this is a fairly general, innocuous recommendation. Of concern though is the extent to

¹ DAC, (1996) "Shaping the 21st Century: the Contribution of Development Co-operation", May, Development Assistance Committee of the OECD, Paris, 20 pp.

² OECD, (2001) *Development Co-operation 2000 Report*, The DAC Journal 2000, Vol. 2, No. 1; OECD, Paris, pp. 96-97.

³ UN (2001) "Report of the High-Level Panel on Financing for Development", Executive Summary, Recommendation 4, UN, New York & Geneva. [<http://www.un.org/reports/financing/summary.htm>]

which the growing emphasis on FDI is both displacing adequate debate on the scandalously low levels of ODA, and fostering an uncritical stance towards FDI itself.

FDI flows are certainly extremely important. They rose 18% in 2000, to a record \$1.3 trillion⁴ (UNCTAD, 2001a). But latest UNCTAD estimates point to a *decline* of 40% of FDI for 2001 – down to \$760 billion – due mainly to a pause in the frenetic pace of mergers and acquisitions (M&As) seen over the last two years.

Given that these M&As took place mainly between developed countries, which account for the bulk of FDI flows, of more relevance is the proportion of FDI flowing to developing countries. Unfortunately, based on UNCTAD's preliminary estimates, this is also predicted to decline this year, from \$240 billion in 2000 to \$225 in 2001. One encouraging sign is that Africa is projected to receive an increase in FDI, from \$9.1 billion in 2000 to \$11 billion this year, though this follows a slump from \$10.5 billion in 1999.⁵

Even so, it is obvious that FDI flows into developing countries are dwarfed by flows to the wealthier OECD countries. To what extent then can FDI fill the gap in providing “financing for development”? Given the urgency of the need for external resources, should FDI be sought out and accepted uncritically? Moreover, what is the appropriate role for transnational corporations (TNCs), and corporate codes of conduct in the development of poor countries?

To many people, and some NGOs, the latter question hardly warrants consideration. In an era of ‘corporate globalisation’, the TNCs are the enemy – and no good can come from consorting with the enemy.⁶

However, things are not so simple. There are both benefits and costs to FDI by TNCs in developing countries. This paper explores some aspects of the costs and benefits of FDI, and in particular the question of appropriate FDI policies. The pros and cons of codes of conduct are then discussed in this context.

2. The Developmental Context of FDI

2.1 FDI and Economic Growth

Investment has long been recognised as one of the keys to economic development, though its precise relation to economic growth remains controversial. While some studies, such as that of de Long and Summers (1991 & 1992), concluded that the rate of capital formation, *determines* the rate of growth, others, such as Blomström *et al.* (1996) refute this claim. They argue that while fixed (capital equipment) investment may be important, other factors such as institutions, the economic and political climate, inflows of FDI, lower population growth, and the efficient use of investment are also critical for strong growth.

Poon and Thompson (1998) analyse FDI and growth data between 1987 and 1994 and conclude that both Japanese manufacturing FDI to Asia, and US service FDI to Latin America, both contributed to the growth of those regions.

⁴ All dollar amounts are in US dollars.

⁵ UNCTAD (2001b). These estimates were made on 3 September 2001, before the events of September 11 which are likely to exacerbate the economic downturn and increase uncertainty, leading to delays or cancellations of investment projects.

⁶ One recent, imaginatively-titled book, was even called *Corporations Are Gonna Get Your Mama* (Danaher, 1997).

On the basis of a time series and panel data analysis of FDI and growth, de Mello (1999) showed that while FDI is meant to increase growth in recipient countries via technological upgrading and knowledge spillovers, in fact, its effects are sensitive to the degree of complementarity and substitution between FDI and domestic investment. Moreover, in his earlier survey of the effects of FDI on developing countries, he concluded that the final impact of FDI on output growth depends on the scope for efficiency spillovers to domestic firms (de Mello, 1997). It is by this means that FDI leads to increasing returns in domestic production, and increases in the value-added content of FDI-related production.

In other words, FDI certainly can contribute to economic growth, but whether it does so, and the extent to which it does so, are significantly influenced by other factors specific to the local economic environment. The appropriate role of FDI, and therefore of TNCs, must therefore be viewed in the much larger context of an appropriate domestic development strategy. It is here that one of the principle dangers of an unbalanced approach to FDI lies.

2.2 The Importance of a Domestic Development and Investment Strategy

Dani Rodrik, professor of international political economy at the John F. Kennedy School of Government at Harvard University, has been particularly scathing of an uncritical approach to global economic integration. In his view, such an approach allows an obsession with integrating into the global economy to obscure the necessity for the careful formulation of a sound domestic development strategy:

Countries that have done well in the postwar period are those that have been able to formulate a *domestic* investment strategy to kick-start growth and those that have had the appropriate institutions to handle adverse external shocks, not those that have relied on reduced barriers to trade and capital flows. Policy makers therefore have to focus on the fundamentals of economic growth – investment, macroeconomic stability, human resources, and good governance – and not let international economic integration dominate their thinking on development. (Rodrik, 1999, p. 1).

He is particularly critical of an overemphasis on trade and capital market liberalisation:

Global integration has become, for all practical purposes, a substitute for a development strategy. This trend is bad news for the world's poor. The new agenda of global integration rests on shaky empirical ground and seriously distorts policy-maker's priorities. By focusing on international integration, governments in poor nations divert human resources, administrative capabilities, and political capital away from more urgent development priorities such as education, public health, industrial capacity, and social cohesion. ... [G]lobalization is not a short-cut to development. Policy-makers need to forge a domestic growth strategy by relying on domestic investors and domestic institutions. The costliest downside of the integrationist faith is that it crowds out serious thinking and efforts along such lines. (Rodrik, 2001, p. 55).

Illustrative of Rodrik's emphasis on the importance of a domestic development strategy is Korea's well-known aversion to FDI in the early stages of its development. The Korean government had an explicit strategy of developing domestic technical capability through technology licensing, financed through foreign loans and import taxes rather than through FDI, except in the light manufacturing export sector. In almost all years from 1965 to 1989, FDI as a percentage of total foreign capital inflow fell below 5% (Amsden, 1989, p. 76).

Even today, FDI for most countries (66% in 1991-97) is not more than 10% of total investment, although those countries with ratios equal to or above 15% increased from 7% to almost 25% between the 1970s and late 1990s (UNCTAD, 1999b, p. 168).

Rodrik's comments are also all the more pertinent when account is taken of the geographical bias of FDI flows. UNCTAD (2001a) notes that the world's top 30 host countries (including the OECD countries) account for 95% of total world FDI inflows and 90% of stocks.

Kozul-Wright and Rowthorn (1998) develop this theme, emphasising the regional nature of much FDI. They argue that unlike Malaysia, located at the hub of a fast-growing, integrating region, most developing countries will be unable to rely on substantial FDI, and will instead have to rely overwhelmingly on their own resources and domestic producers.

Two major conclusions follow from this section:

First, while FDI can contribute to economic growth, whether it does so is highly dependent on the domestic economic environment.

Second, while FDI will be important for some countries, there is simply not enough FDI to assist most developing countries, especially the poorest. Most such countries still require substantial amounts of ODA to lift their populations out of poverty and all require a well-crafted domestic development and investment strategy.⁷

At a deeper level still, lies the issue of the costs and benefits of the FDI that *is* available. In discussion of FDI, TNCs and codes of conduct, it is often just assumed that FDI is beneficial and that the real question then is the conduct of the companies concerned. It will be argued here that while company conduct, and therefore codes of conduct are obviously important, we must not neglect the prior question of whether a given investment is in fact likely to benefit the host country. Should developing countries simply solicit and accept any FDI?

3. Costs and Benefits of FDI

3.1 Cost-Benefit Analysis and FDI

It is widely acknowledged in principle that there are economic and social costs as well as benefits from FDI (and the international competition for FDI). But in practice this increasingly seems to be forgotten.

Like other major projects, FDI should not be accepted (or solicited) uncritically, but instead evaluated in a comprehensive economic and social cost-benefit framework. This should include appropriate shadow prices (especially for government revenue, foreign exchange and labour), appropriate discount rates and appropriate distributional weights⁸. Shadow prices are prices calculated to take into account the true opportunity costs of resources and inputs and any externalities resulting from the project. These can be negative, such as pollution, congestion or crowding out of domestic capital, or positive, such as technological spillovers or higher productivity. Appropriate social discount rates are essential because it is well known that private rates of return and discount rates can diverge markedly from optimal social rates of return and discount rates. Private interests tend to discount the future more heavily (i.e. use higher discount rates) than is optimal from a broader social perspective – especially in an environment where property rights or regulations are ill-defined and a 'tragedy of the commons' effect can ensue. Appropriate distributional weights should be used to account for equity considerations. An investment project which yields 100 already-rich people \$50,000 each, is by no means as developmentally effective as one which yields 50,000 very poor people \$100. To ignore distributional weights is to assume an effective distributional weight of '1' for the 'average' income level. This assumes 'a dollar is a dollar', and that an extra dollar's benefit to a rich person is identical to an extra dollar's benefit to a very poor person. This may make the calculations easier, but it ignores

⁷ See also Lensink & White (1998) on this.

⁸ See for example: Brent (1998), Dinwiddy & Teal (1996) and Squire (1989).

the vast empirical evidence to the contrary and the entire economic theory of diminishing marginal utility of income.

The over-arching context for the cost-benefit evaluations should be the country's own development strategy, incorporating fundamental goals such as social development, poverty reduction and industrial diversification. A simplistic financial accounting framework that accepts any project that will bring in \$X million and 'create' X-thousand jobs is therefore manifestly inadequate.

Little and Mirrlees (1991), two of the founders of cost-benefit analysis, were very critical of its woeful neglect by the World Bank in its own projects at the Bank's 1990 Annual Bank Conference on Development Economics. This neglect, as Little and Mirrlees emphasised, was a "shattering indictment" of the Bank's operations, because shadow prices are nothing less than the marginal effects on social welfare of any quantity change. They are the true opportunity costs of a resource use: "Shadow prices and cost-benefit analysis are inseparable. Sometimes actual prices coincide with their shadow values, as if on the equator in the midday sun. Only then is financial analysis also cost-benefit analysis."⁹ Unfortunately, its practice by most developing country governments is unlikely to be significantly better than the Bank's.

But if these factors are not taken into account in assessing the desirability of a given FDI, there is no way of knowing beforehand whether the investment will benefit the country or harm it. To assume that FDI *must* be beneficial is ideology – not economics.

For example, Young and Miyagiwa (1986) showed that a country can in fact be immiserised through foreign investment via the growth of its labour force, which increases the payments that have to be made to foreign investors. This occurs when both the elasticity of substitution between labour and capital and the elasticity of supply of foreign capital are both low and there is no tax on returns paid to foreign capital.

Such adverse outcomes have also been noted empirically, as Helleiner (1989, p. 1457) and Cardoso and Dornbusch (1989, p. 1415) point out. In particular, both Reuber's (1973) and Lall and Streeten's (1977) studies found that around *one-third* of the foreign investment projects analysed *reduced* the host country's national product. Similarly, Encarnation and Wells (1986) discovered that 25-40% of projects earned *less* in terms of the opportunity costs of resources, than the country paid for them.

Meier (1995, p. 260) illustrates a useful basic cost-benefit equation whereby FDI could be evaluated:

$$\mathbf{NSB} = \mathbf{SP}_{\text{outputs}} - \mathbf{SP}_{\text{inputs}} + \mathbf{Net Externalities} + \mathbf{K inflow} + \mathbf{Return to domestic investors} + \mathbf{Taxes \& Royalties} - \mathbf{D \& K repatriated in foreign exchange}.$$

Where: **NSB** = Net Social Benefit; **SP** = shadow price; **D** = Dividends, interest and profits; **K** = capital

As Meier notes: "Considering the stream of social benefits and social costs and discounting to the present, it would be in the interest of the host government to allow entry if the present value of the NSB is greater than 0 at a social discount rate".

A small number of cost-benefit analyses have been carried out in an effort to assess the impact of FDI overall on particular countries. Shiong (1997) analysed the costs and benefits of FDI in Malaysia using a Little-Mirrlees (1974) framework, and with/without investment scenarios. Shiong weighed the benefits against costs for Malaysia, and concluded that "the positive benefits of foreign direct investment are far higher than the negative ones, and similar investment should be strongly encouraged".

⁹ Little & Mirrlees (1991) as reprinted in Layard & Glaister (1994), p. 210.

Table 1 summarises some of the potential costs and benefits of FDI offsetting them where appropriate. It is illustrative, not exhaustive.

Table 1. Summary of some of the potential costs and benefits of FDI.

Potential Costs of FDI	Potential Benefits of FDI
<ul style="list-style-type: none"> • Potential crowding-out of locally-funded investment 	<ul style="list-style-type: none"> • Increased local investment via availability of new (foreign) capital
<ul style="list-style-type: none"> • Losses suffered by local entrepreneurs because of greater competition for labour 	<ul style="list-style-type: none"> • Increased employment
<ul style="list-style-type: none"> • Increased market concentration through loss of domestic competitors 	<ul style="list-style-type: none"> • Increased competition improving overall efficiency
<ul style="list-style-type: none"> • Investment in enclaves contributing to dualistic economic structures 	<ul style="list-style-type: none"> • Backward (and forward) linkages to domestic industries
<ul style="list-style-type: none"> • Loss of domestic control over key strategic industries 	<ul style="list-style-type: none"> • Demonstration effects on local industries on issues such as export behaviour, technology choice, managerial practices
<ul style="list-style-type: none"> • Local staff may be given only junior positions 	<ul style="list-style-type: none"> • Training of local labour and staff turnover from TNCs to domestic firms
<ul style="list-style-type: none"> • Reduced incentives for local R&D if technological spillovers are extensive 	<ul style="list-style-type: none"> • Technology transfer & spillovers – including technical assistance to suppliers and customers
<ul style="list-style-type: none"> • Greater risk of withdrawal of investment than with domestic investors 	<ul style="list-style-type: none"> • Cheaper, high-quality locally-manufactured import substitutes
<ul style="list-style-type: none"> • Negative net resource flows and adverse Balance of Payments outcomes once profits are repatriated. 	<ul style="list-style-type: none"> • Tax revenues on the project after the tax holiday period and income tax payments by foreign specialists
<ul style="list-style-type: none"> • Abuse of transfer pricing leading to loss of government tax revenue. 	
<ul style="list-style-type: none"> • Capital inflow causes exchange rate to appreciate. 	
<ul style="list-style-type: none"> • Increased inequality 	
<ul style="list-style-type: none"> • Restrictions on subsidiary’s exports by parent company 	

It is obviously beyond the scope of this paper to consider all of these issues in detail, so the following discussion will merely highlight some of the most pertinent considerations in evaluating potential FDI, highlighting the diversity of outcomes in different contexts.

3.2 FDI and Technological Spillovers

One of the most commonly emphasised potential benefits of FDI is the “technological spillover” effect, and while FDI can undoubtedly facilitate technology transfer, the evidence on this is more mixed than one might be led to believe.

Aitken and Harrison (1999), for example, examined the evidence on the impact of FDI on 4000 firms in Venezuela from 1976-1989 and found that while productivity improved in small plants (with less than 50 employees) with foreign equity participation, it *reduced* the productivity of wholly domestically-owned plants in the same industries. The overall effect of the foreign investment with these two offsetting forces was “quite small”, and the gains appeared to be captured entirely by joint ventures. They also “found no evidence of technology ‘spillovers’ from foreign firms to domestically-owned firms”.

Conversely, Chuang and Lin's (1999) study of 8,846 Taiwanese firms using 1991 census data found beneficial spillovers to domestic firms from FDI: A 1% increase in an industry's FDI ratio produced a 1.40-1.88% increase in domestic firm's productivity. However, they also noted that this diffusion of technological learning can have the effect of *reducing* local firms' incentives to conduct their own R&D. They therefore recommended, once a country's technical capacity has reached a desired level, that policies be introduced to encourage local firms to conduct their own R&D.

Positive externalities from FDI such as technology spillovers are also highly sensitive to market structure and to any strategic interaction between firms. Analysing detailed micro-level data from Indonesian firms, Sjöholm (1999) found that competition increases the degree of spillovers from FDI since it spurs TNCs to transfer more modern technology to their affiliates. This reinforces the similar results of Blomström *et al.* (1994) and Kokko (1996). But Blomström and Kokko (1996) also point out that while FDI may initially increase competition in developing countries, it may also eventually reduce it if local firms are driven out of business. This is especially true if the foreign firm engages in unfair, anti-competitive practices, such as predatory pricing, because it is able to sustain heavy initial losses by cross-subsidisation from its parent or affiliate companies. Appropriate FDI policy for a given sector therefore depends on a careful analysis of local market structure to maximise the scope for technological spillovers and other positive externalities. It should not be assumed that they will automatically materialise.

3.3 FDI, Wages and Income Inequality

TNCs are often accused of 'exploiting cheap labour', but it is important to bear in mind local wage rates, assuming that these are not kept artificially low by repression and persecution of labour leaders. Given this caveat, evidence suggests that TNCs can have a *positive* effect on local wage rates. Lipsley and Sjöholm's (2001) study of 19,911 firms in Indonesia, and the Aitken *et al.* (1996) analysis of firms in Mexico, Venezuela and the United States, both support the conclusion that TNCs tend to pay higher wages than their local counterparts. In some cases they also induce local competitors to pay higher wages than they would have otherwise.

The question of the relationship between FDI and income inequality has also been controversial. Recently Tsai (1995) undertook a major cross-country regression study of the issue, paying particular attention to data comparability and model specification. Tsai also introduced geographical dummy variables, which have largely been absent from previous studies that found that FDI increased inequality. Tsai concluded that the geographical factors in fact capture a large degree of the inequality, and that only in East and South East Asia did FDI appear to have contributed to inequality in the 1970s.¹⁰

3.4 The Trade Regime and Sectoral Considerations

The trade regime and sectoral considerations exert an enormous influence on whether FDI is likely to be beneficial to a country or not and they greatly complicate any facile assumption that FDI is beneficial no matter where it goes. Helleiner (1989, p. 1457) noted, for example, that bad projects with negative social rates of return tend to be systematically associated with higher levels of domestic protection against imports.

Buffie (2001) used a series of optimising dynamic general equilibrium models to investigate the welfare effects of FDI under various trade regimes. He emphasised that the fear that FDI will crowd out domestic investment "is a legitimate economic concern, not just raw xenophobia. When the return on capital exceeds the social time preference rate, crowding out of domestic investment is associated with a welfare loss" (p. 293-294). This potential welfare loss has to be weighed against the purported benefits of FDI. He is particularly critical of FDI in the domestic manufacturing sector, especially if it

¹⁰ Tsai emphasises that this result refers only to the marginal effect not the total effect.

is protected, since while unemployment may decline in the short run, it generally rises in the long run. Moreover, FDI can crowd out domestic capital so strongly that the aggregate capital stock and employment in the high wage manufacturing sector *decline*.

Rodríguez-Clare (1996) has shown that the linkage effects and benefits of FDI to the local economy are generally stronger when companies intensively use locally-produced intermediate inputs. When FDI creates enclave economies with few local linkages it can, under some circumstances, harm the developing economy.

In short, it matters what sector of the economy FDI flows into and whether that sector has potential for ongoing strong linkages to the local economy. Poon and Thompson (1998, p. 155) suggest for example that Japanese service sector FDI had virtually no impact on economic growth in either Latin America or Asia between 1987 and 1994 because investments in the late 1980s were largely in relatively unproductive real estate.

In addition, investment in some sectors is arguably directly harmful. There are grave concerns in some developing countries over the increased investment by OECD country 'Big Tobacco' companies, with all the associated negative public health externalities. Weissman (1998) notes that due to stagnant or declining sales in the developed countries, tobacco companies are increasingly looking to developing countries for their profits. In a similar vein, the South Centre (1997, p. 38) emphasises the social costs of FDI in 'junk food' production and distribution among the poor, especially in urban areas. Such junk food may displace more nutritious (and cheaper) local foods, leading to losses of income for farmers and poorer diets and increased diabetes and heart disease for consumers. It is entirely possible that the net social returns of such investments are negative.

The nature of the trade regime also directly affects optimal FDI policy. Very different policy recommendations on domestic equity requirements are required for example, depending on whether imports are restricted by tariffs or by quotas, and depending on the degree of capital mobility. Using a general equilibrium model, Chao and Yu (2000) demonstrated that with quotas, increasing the equity requirements improved welfare in the short run but reduced it in the long run. Conversely, with tariffs, domestic equity requirements lower welfare initially but raise it over the long term.

The possibility or threat of FDI can also act endogenously to affect the trade regime itself. Ellingsen and Wärneryd (1999) make the point that since a high level of protection is an inducement for foreign firms to set up domestic operations, this acts as a break on domestic firms' desire for increased protection. The threat of FDI, and hence increased local competition, is likely to be of greater marginal concern than more imports.

3.5 FDI, Transfer Pricing and Tax Avoidance

Abuse of intra-firm transfer pricing remains a serious problem for developing country governments dealing with TNCs (UNCTAD, 1999a,b). Intra-firm trade prices may be under or over-invoiced in order to shift profits for tax purposes or to evade trade taxes or foreign exchange controls. The lack of transparency of such trades and the difficulties of monitoring make this one of the prime sources for the power disparities between local firms and TNCs. Transfer prices can be used to cross-subsidise affiliates to undercut and drive out local competition.

This is related to the problem of the use of tax havens and capital flight through over-invoicing imports and under-invoicing exports – the means by which foreign assets can be accumulated and sold in the black market (Cardoso & Dornbusch, 1989, p. 1427). On the import side, incentives to under-invoice imports in order to avoid import taxes, work in the opposite direction from incentives to over-invoice in order to effect capital flight. However, on the export side, under-invoicing achieves both goals. Hence export under-invoicing is rife. Cuddington (1986) for example found that between 1977-

1983, exports were under-invoiced by an average of: 19.6% in Argentina, 12.7% in Brazil, 12.8% in Chile, 33.6% in Mexico and 27.8% in Uruguay.

More recently in the *Wall Street Journal*, Phillips (1999) reported that the US Internal Revenue Service estimates that transfer pricing abuses costs the US government \$2.8 billion each year. Finance professors John Zdanowicz and Simon Pak from Florida International University in Miami put the figure closer to \$35.6 billion in 1998:

Combing through anonymous Customs records, the researchers found \$18,000 dot-matrix printers being imported from Japan and \$2,600 radial tyres coming from Indonesia. And somebody in the U.S. is exporting \$12,000 helicopters to Italy and \$135 howitzers to South Africa.

These kinds of results make it difficult to assess the true trade consequences of FDI and undoubtedly result in large losses of fiscal revenues for governments.

3.7 FDI and Balance of Payments Considerations

This is a complex area which is beyond the scope of a short paper, but it is important to note that FDI can have unforeseen and unhelpful macroeconomic consequences under the wrong circumstances. In essence the problem is that while the initial investment is a capital inflow, assuming the investment is profitable, this will eventually become a net outflow of foreign exchange as profits are repatriated. While this is not necessarily bad in and of itself, since the FDI project can still be a net gain for society, it does mean that the country has to finance this outflow somehow. If the investment has been productive and in an export sector earning foreign exchange, this is unlikely to be a problem. But, again returning to sectoral considerations, if the investment was in, say domestic non-traded services, or in domestic marketing and retailing, especially of imports (such as a supermarket), the foreign exchange demands could be a very significant problem (South Centre, 1997, p. 47).

FDI is also assumed to be far more stable than portfolio 'hot money' investments, but this assumption has also been questioned by World Bank research. Claessens *et al.* (1995) used time-series analysis of balance of payments data for five industrial and five developing countries and found that long-term flows were often as volatile and at least as unpredictable as short-term flows.

The balance of payments considerations and potential volatility of FDI should therefore not be ignored or underestimated.

4. Policy Instruments

This section will concentrate on just four of the main policy issues influencing the benefits of FDI before a more in-depth discussion of another instrument, corporate codes of conduct, in Section 5.

4.1 Export Requirements

A number of commentators have highlighted export requirements as an important means by which developing countries can capture more of the benefits of FDI.

Rodrik (1987) showed that in the presence of a 'second-best' environment which includes tariffs and oligopolistic behaviour in host-country markets, export-performance requirements can improve national welfare by reducing payments to foreign capital, reducing the output of overproduced commodities, and shifting profits towards domestically-owned firms. Chao and Yu (1996) also showed that for a small 'full employment' economy with tariffs, an investment tax linked with export requirements is the most desirable policy.

Buffie (2001, p. 367) concluded that export requirements are the *only* way in some circumstances, (such as with FDI in the protected domestic manufacturing sector), to ensure that FDI does not *reduce* social welfare. He even showed that when there is strong crowding out of domestic capital, the export requirement may need to be as high as 55-70% of output.

4.2 Technology Transfer and Joint Venture Requirements

Some governments have made technology transfer or joint ventures an explicit condition of FDI. However the results of such policies are mixed.

Kokko and Blomström (1995) for example, studied the manufacturing operations of majority-owned foreign affiliates of US TNCs in 33 host countries in 1982. They found technology upgrading and imports were best encouraged by increasing levels of competition to erode the TNCs' technological advantages, and also improving the skills of the local workforce to enhance their capacity to absorb technological improvements. Conversely they found a negative relationship between performance requirements and technology transfers reflected in data on payments of royalties and license fees. However, such performance requirements had little effect on technology transfer embodied in machinery and equipment.

Joint ventures are one popular means of trying to ensure technology-transfers, but Moran (1999, pp. 9 & 199-125) found scant evidence that this was effective. In general, technology transferred to compulsory joint venture partners tended to be older, and when forced, such alliances are often fraught with difficulties.

4.3 Education and Training

Borensztein *et al.* (1998) analysed the effects of FDI on a cross-section of 69 developing countries during the 1970s and 80s, and concluded that FDI was indeed an important vehicle for technology transfer. However, they also found that the higher productivity produced by FDI held only when the host country had a minimum threshold stock of human capital (proxied by educational attainment)¹¹. Moreover, they contend that "FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy" (p. 115). More concerning, they also point out that for countries with very low levels of human capital, the direct effects of FDI are negligible or negative (p. 123).

Xu (2000) evaluated the performance of US TNCs as a channel for technology diffusion in 40 countries from 1966 to 1994. He also found that while the technology transfers boosted productivity in developed countries, they did not do so for less developed countries below a minimum level of human capital availability. Similarly, Blomström and Kokko (1998) found that the positive effects of FDI tended to increase with the level of local labour capability and the degree of competition.

These results highlight the importance once again of the domestic development strategy, focussed on enhancing national capabilities.

4.4 Taxes and Incentives

The escalation in incentives is another serious problem, and a zero-sum game overall for competing governments. Usher (1977) outlined the complexities of designing an appropriate incentive program, given extensive technical change and the problem of redundancy in incentives – a problem exacerbated in a context of competition between governments which is resulting in firms capturing more and more of the overall benefits of FDI.

¹¹ A point that is reinforced by Balasubramanyam, *et al.* (1999).

Developing countries increasingly try to tempt scarce FDI with elaborate overtures. In 1997, the Economist ran a four page 'Promotional Feature' by the Government of Nigeria, then under the dictator General Sani Abacha. The extensive list of incentives offered included the following, showing that even labour rights violations are not beyond the purview of some governments:

Under the laws of the export processing zones in Nigeria, investors are exempted from all forms of taxes and levies. They have unrestricted exportation and repatriation of capital and profits rights, duty free importation of goods, exemption of such goods from pre-shipment inspection and 100 percent business ownership, foreign or local. Apart from the tax holiday, *there is a 10-year ban on labour strikes and lockouts in the zone*. Protection of investments is also guaranteed. Getting business done at the Calabar Export Processing Zone is very easy. It is a 'one stop' approval system.¹²

Such lavish inducements are by no means confined to the developing world however. In 1996, the US State of Alabama for example, won the contract for Daimler-Benz's new plant employing around 1500 people - after Alabama had yielded a \$300 million package of tax breaks and subsidies - that is, \$200,000 per job. The same year Germany gave Dow Chemical a \$6.8 billion subsidy for a plant employing 2000 people, which translates to \$3.4 million per job (Moran, 1998, p. 97).¹³

But Haaparanta (1996) has shown that paying higher subsidies than other countries is by no means a guarantee of securing increased FDI. Furthermore, with such incentive competition comes the temptation to reduce taxes, but this must also be carefully considered. Chitrakar and Weiss (1995) undertook a cost-benefit evaluation of FDI in Nepal in the 1980s. They concluded that FDI had indeed benefited Nepal, but that most of this benefit came through tax revenues – and specifically from sales and excise taxes rather than profit taxes. They therefore urged caution with regard to long tax holidays and that “foreign investment should be approached from a bargaining perspective, rather than one of uncritical welcome” (p. 464).

Buffie (2001, p. 318, 368) also showed that while FDI in an export enclave is normally welfare improving (if profits *aren't* taxed), in a diversified economy that exports both primary products and manufactures, this result is weakened. In fact, FDI “crowds in domestic capital and reduces unemployment only if foreign profits are taxed at a sufficiently high rate. *Ceteris paribus*, the required tax rate is lower the more resource/capital intensive is the export product.”

Hanson (2001) is also critical of incentives such as subsidies to attract FDI, especially given the weak evidence for technological spillovers. He argues that Brazil's subsidies to motor vehicle manufacturers may have lowered national welfare, whereas Costa Rica was wise not to offer Intel subsidies to invest.

Competition to offer more and more lavish inducements to potential investors can be inimical to appropriate FDI policies, and can in fact turn otherwise beneficial projects into ones which *reduce* overall welfare. Great care must be taken to ensure that any incentives offered to firms do not tip the balance from a net benefit to a net cost. Again, this 'balance point' will only be located if a proper cost-benefit analysis is undertaken.

5. Corporate Codes of Conduct

What is the role of corporate codes of conduct in all of this? Without question they have proliferated in the last two decades. The ILO first issued its *Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy* in 1977, revising them in 1991 (ILO, 1991). Last year the

¹² Nigeria (1997), "Calabar Export Processing Zone", *The Economist*, Vol. 342, No. 8004, February 15, pp. 79-82. Emphasis added.

¹³ These examples are a small example of the broader problem of state subsidised corporate welfare in both domestic and foreign investment. See the series in *Time* by Barlett and Steele (1998).

OECD (2000b) revised its 1976 *Guidelines for Multinational Enterprises* after consultation with a wide variety of stakeholders. Beyond these two well-known examples lie thousands of individual company, association and international codes.

Opinions differ markedly on their role and utility. At one extreme, some view voluntary codes of conduct as window dressing at best, and misleading public relations exercises at worst. Others see an important role for codes of conduct in 'raising the bar'. Much of course depends on three factors, which will be discussed in turn: First, the issues that are included in the codes; second, how these codes are promoted, monitored and enforced; and third, what gets left out of the codes.

5.1 The Content of the Codes

Corporate codes of conduct vary enormously in their scope and purpose. The new OECD *Guidelines for Multinational Enterprises* is certainly an important document with the potential to provide a useful benchmark for improving the social and environmental performance of TNCs. Last year the OECD (2000a) reviewed 246 other voluntary codes of conduct from companies (48%), associations (37%), partnerships of stakeholders (13%) and international organisations (2%). The codes were dominated by labour and environmental concerns, with consumer protection, bribery and corruption also featuring strongly.

In an earlier study, Kolk *et al.* (1999) examined 132 codes, including 11 'macro' codes from organisations such as the ILO, OECD, UNCTAD and the WHO, 84 'micro' codes from individual TNCs, and 37 'meso' codes – 13 from social interest groups and 24 from business groups. They analysed the codes in terms of three categories:

Social – including employment, training, working conditions, industrial relations and force;

Environmental – including management policies, input/output, stakeholders, finance and sustainable development;

Generic – including consumer interests, communities, global development, ethics and legal requirements;

Obviously different codes focus on different aspects of these three categories depending on their purpose. This section of the paper concerns primarily the ability of codes of conduct to modify TNC behaviour in a 'pro-development' way. At this stage then, we are interested not just in what the codes tend to cover, but in what difference they make. For these purposes, more important than the coverage of particular issues, is a code's *compliance likelihood*:

Compliance likelihood is determined by the compliance mechanisms included in the codes and the extent to which claims put forward are measurable. The more specific the codes are, the better they can be measured and, subsequently, monitored (Kolk *et al.*, 1999, pp. 153-4).

A major component of the content of the codes is therefore how *specific* they are. Are they simply general platitudes, or are they built around specific goals and targets?

On a scale ranging through 'General', 'Frail', 'Moderate', 'Mod/Strong' to 'Strong', Kolk *et al.* (1999, p. 162) found that in fact 45.8% of business groups' codes and 40.5% of firms' codes were 'General', leaving much room for interpretation. Those classed as 'Frail' (predominantly general) accounted for a further 33.3% of business group codes and 20.2% of firm codes. In other words, nearly 80% of business groups' codes and over 50% of firm codes were either completely or predominantly *General*. At the other end of the scale, just 12.5% of business group codes and 25% of firm codes were 'Mod/Strong' or 'Strong', containing predominantly specific prescriptions and restrictions.

In order to be able to monitor performance, one has to have something to measure. Yet, in van Tulder and Kolk's (2001) analysis of codes of conduct in the sporting goods industry, the authors found that

61% of the 84 general corporate codes of conduct in their reference group contained not a single quantitative standard. None of the sporting goods codes described monitoring systems and processes in any detail. Kolk *et al.* (1999, p. 163) found similar results with only around 10% of codes having more than *one-quarter* of their statements attached to quantifiable measures.

Related to measurability is the time horizon envisaged. Again, Kolk *et al.* (1999, p. 163) found that 73% of codes had no time horizon defined at all, and a further 13% were vague. In just 14% of cases was the time horizon clear.

Assuming, not unreasonably, that a more specific, measurable code is more likely to influence specific behaviours than a general one, these results suggest that there is a great deal of room for improvement in the content of codes – if their goal is in fact to influence firm behaviour.

5.2 Promotion, Monitoring and Enforcement

At least as important as the development of the content of a particular text is the institutional framework that determines the extent to which it is promoted, implemented, monitored and enforced. Here the record is even more patchy.

According to the OECD (2000a, pp. 30 & 35) 66% of the 246 codes they analysed and 71% of all company codes mention some type of monitoring procedure, but these are overwhelmingly *internal* procedures. This leaves around 30% of codes which do not mention any type of monitoring *at all* - a result confirmed by van Tulder & Kolk (2001, p. 274). Of the 118 company codes analysed by the OECD, only 45 had provisions for reporting on performance, and of these, only 24 provided for external reporting. More concerning was the finding that only 4 mentioned independent, external monitoring and only 2 mentioned a formal complaint body. Kolk *et al.* (1999) reinforce this general picture, discovering that not only do 32% of firms codes do not mention any type of monitoring at all, the majority of firm codes (58%) only envisage self-monitoring.

Of particular concern is the finding of the Council on Economic Priorities (1998), that of those firms with sourcing guidelines based on labour rights, only 44% actually bothered to monitor the implementation of the codes. Even then, this was again undertaken internally in the vast majority of cases (as cited in Kolk *et al.*, 1999, p. 169).

It is important to emphasise that the necessity of independent monitoring is directly related to the vagueness of the code:

Although an independent monitoring party increases compliance likelihood, the strictness of the code also plays a role. If criteria are very strict, even a relatively dependent actor might suffice, whereas independence will be crucial when vagueness prevails. (Kolk *et al.*, 1999, p. 168).

It is hardly surprising that independent monitoring is probably the most neglected dimension of the 'codes of conduct' issue. Fine words and noble intentions are easy to write (and a delight to market), but monitoring, transparency and compliance are more painful and entail more far-reaching changes to corporate cultures and practices than many companies are prepared to countenance.

Yet this is precisely where the credibility of the codes is forged – or lost. World Vision works with a few TNCs around the world – often on a purely advocacy basis, and in other cases more co-operatively. We recently experienced a situation where a company was wanting to work with us. They had an impressive code of conduct, which was meant to be monitored by external auditors. We tried to explain that we couldn't just take their word for it that they were improving conditions in their factories – we needed some external verification. We struggled for months to get them to show us copies of the audits – or at least a representative sample. Finally we were allowed to view a small

number of summaries, with many important details deleted. This was both disappointing and inadequate.

Some codes are quite promising. These include Social Accountability International's SA8000 accreditation system modelled on the ISO9000 'Quality' series¹⁴; the Code of Labour Practice adopted in 1996 by the Fédération Internationale de Football Association (FIFA) – which includes detailed compliance mechanisms and severe sanctions for non-compliance; and the 1997 WorkPlace Code of Conduct produced by the Apparel Industry Partnership (AIP) – which is more specific than most firm codes, is monitored both by the firms and external monitors and includes sanctions for non-compliance (Kolk *et al.*, 1999, p. 157).

5.3 Issues Omitted

Just as important as the issues included in codes of conduct are the issues that are omitted, since it is often these other factors which have a major influence on whether FDI is socially beneficial or harmful in developing countries.

The OECD (2000a, pp. 15,16) found that:

- 61% of company codes do not mention disclosure of relevant information.
- Only around 20% have any mention of competition, and most of these are very general.
- Only 32% of codes committed firms against making political contributions.
- Only 1 code out of 246 mentioned the issue of taxation.

But as has been discussed previously, these issues – degrees of competition and appropriate taxation particularly - are precisely some of the key factors that should be considered in a cost-benefit analysis of FDI.

Likewise, disclosure of relevant information and refraining from interfering in the political process by making inappropriate campaign contributions are also critical for well a functioning polity and sound policy, yet these are barely mentioned. The studies of the corporate use and abuse of public relations strategies by Stauber and Rampton (1995) and Beder (1997) suggest that this is a tremendously importance omission.¹⁵

One gem came from the web site of a large PR firm in 1998:

[Firm Name]: Managing perceptions that drive performance
Perceptions are real. They color what we see ... what we believe ... how we behave. They can be managed ... to motivate behavior ... to create positive business results. ... At [Firm Name] we believe that ... [t]he role of communications is to manage perceptions in order to motivate behaviors that create positive business results. ... In this age of accelerating change and borderless, instantaneous communication, the proactive management of perceptions has never been more important. [Firm Name] is in the Perception Management business. We are focused on adding value to our clients through the use of Perception Management.

Knowing that some companies spend tens of millions of dollars on PR firms such as Burson-Marsteller, Ketchum, Hill and Knowlton and Fleischman-Hillard to 'manage' our perceptions, we can be certain that things are not always as they appear.

A chilling recent example of the corporate abuse of PR was exposed last year in the respected medical journal *The Lancet* (Ong & Glanz, 2000). The tobacco industry, led by Philip Morris, had attempted to

¹⁴ See: <http://www.cepaa.org/introduction.htm>

¹⁵ For more, see the Centre for Media and Democracy, <http://www.prwatch.org/>

subvert and delay a study on the effects of second-hand smoke undertaken by the WHO's International Agency for Cancer Research, in order to try to prevent more restrictive anti-smoking laws in Europe. The authors maintain that "The documents and interviews suggest that the tobacco industry continues to conduct a sophisticated campaign against conclusions that second-hand smoke causes lung cancer and other diseases, subverting normal scientific processes" (p. 1253).

Related to the concern about the omissions from codes of conduct, is the role that the codes themselves may be playing in relation to national laws. As Gereffi *et al.* (2001) point out, pre-emptive developments of less-stringent voluntary codes have been used by corporations and business groups to head off binding legislation.

5.4 The Place of Codes of Conduct

Voluntary codes of conduct can only go so far towards ensuring positive social benefits from FDI. As discussed previously, far more fundamental is a sound institutional environment with a competent, honest, bureaucracy and judiciary, and laws which protect the environment from excessive pollution and which protect basic workers rights - such as minimum age, health and safety, the right to organise and collectively bargain, and so on. When this basic legal and political framework is functioning well, codes of conduct can be an added spur to even better performance. They can also be useful in encouraging responsible corporate behaviour in a less than ideal political and legal environment. But codes cannot replace this framework. Most importantly, they should not be used to hinder the development of a proper legal framework, or mask the need for one.

Kolk *et al.* (1999, p. 171) conclude with an incisive assessment of an important role which codes of conduct do play at the present time:

Codes – now more than ever before – have the function of deciphering the limits of regulation and the roles of governments, firms and representatives of civil society. Codes are an 'entry to talk'. The agenda-setting potential of codes, therefore should not be underestimated.

Beyond being an 'entry to talk' and helping to set the agenda for future discussions, codes of conduct are probably most useful in proportion to their specificity, measurability, degree of external monitoring, and enforceability. Since the vast majority of current codes fail these tests, the more robust codes mentioned previously such as SA8000, FIFA's Code of Labour Practice, and AIP's WorkPlace Code of Conduct, show most promise of enhancing the benefits of FDI in developing countries.

6. Conclusions

There is no doubt that FDI can contribute to development. However a number of caveats and conclusions may be drawn from the preceding discussion.

First, the scale and geographical scope of FDI falls far short of the extra resource requirements of most developing countries. There remains an urgent need for increased ODA, especially for the poorest countries.

Second, while FDI can contribute to economic growth, and more importantly to improved social welfare, it does not always do so. Furthermore, whether it does or not is *not* related wholly to the properties of the specific project, or the conduct of the individual company. Just as important are the economic and social circumstances of the host country – including factors such as levels of human capital, the trade regime, the degree of competition in local markets, the local shadow prices of foreign exchange, labour and capital, and the local social discount rate.

From this it follows, thirdly, that developing countries must be helped to strengthen their institutional capacities to analyse proposed FDI using a social cost-benefit framework combined with economic models appropriate to the country's economy. More broadly, the importance of a sound and competent local institutional framework can hardly be overemphasised. Well-crafted, appropriate and dutifully enforced competition, tax, labour, health and safety, environmental laws are essential to ensuring that FDI improves overall welfare.

Fourth, on the international policy front, developing countries must retain the freedom to devise FDI policies appropriate to their own circumstances, including measures such as export performance requirements and restrictions on entry to particular sectors. Any moves to curtail these freedoms under future WTO investment negotiations should be strenuously resisted by developing countries.¹⁶

Fifth, FDI must be seen as just one part of an overall, domestic development strategy, focussed on building local capacities and domestic investment. Where FDI can contribute to this strategy and improve overall social welfare, it should be welcomed. But it should not be pursued to the detriment of these primary goals.

Sixth, escalating incentives to attract FDI is ultimately a zero-sum game for governments, diverting government revenues and energies into subsidising TNCs. Developing countries cannot hope to match the resources of the wealthy OECD countries and since the marginal value of government resources are arguably more valuable for them, they should resist trying to do so. Multilateral approaches must be found to curb this harmful competition.

Finally, voluntary corporate codes of conduct vary enormously in what they include, what they leave out, and whether any independent monitoring or enforcement takes place. They therefore vary accordingly in how useful they are. Well-crafted and well-monitored codes of conduct can be a useful adjunct in a sound political and legal environment to help 'raise the bar' of corporate behaviour. They can also be useful in encouraging responsible TNC behaviour in a less than ideal political and legal environment. But they should in no way be used to forestall the development and enforcement of sound environmental, social and labour laws. Neither should they be used to mask the need for a sound economic and social cost-benefit analysis of proposed investments.

Just because a company has a wonderful, well-monitored and well-enforced code of conduct, doesn't automatically mean its investment is going to make a given developing country or region better off. The cost-benefit analysis needs to be undertaken. It might well reinforce the case for a particular investment or even the opening up of an entire sector. But then again, it might not. It might show that a country is better off restricting some types of investments and imposing performance requirements on others.

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¹⁶ For a good discussion of proposals on investment under the WTO from a developing country perspective, see Singh (2001).

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