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In search of FDI-led growth in developing countries: The way forward

Dierk Herzer [a,*], Stephan Klasen [b], Felicitas Nowak-Lehmann D. [b]

[a] *Economic Development and Integration, Johann Wolfgang Goethe-University, Schumannstraße 60, 60325 Frankfurt am Main, Germany*
[b] *Ibero-America Institute for Economic Research, Platz der Goettinger Sieben 3, 37073 Goettingen, Germany*

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Abstract

This paper challenges the widespread belief that FDI generally has a positive impact on economic growth in developing countries. It addresses the limitations of the existing literature and re-examines the FDI-led growth hypothesis for 28 developing countries using cointegration techniques on a country-by-country basis. The paper finds that in the vast majority of countries, there exists neither a long-term nor a short-term effect of FDI on growth; in fact, there is not a single country where a positive unidirectional long-term effect from FDI to GDP is found. Furthermore, our results indicate that there is no clear association between the growth impact of FDI and the level of per capita income, the level of education, the degree of openness and the level of financial market development in developing countries.

JEL classification: F43; C22

Keywords: FDI; Growth; Developing countries; Cointegration

1. Introduction

Foreign direct investment (FDI) has grown dramatically in the past 20 years, exceeding the growth of world production and the growth of international trade. Although most FDI flows are within the developed world, FDI flows have become increasingly significant for many developing countries. Since 1980, FDI to developing economies has increased more than 12-fold (World Bank, 1999). Today, FDI typically accounts for more than 60% of private capital flows to the developing world (Carkovic and Levine, 2005; World Bank, 2006). This world-wide explosion of FDI has been accompanied by a shift in emphasis among policymakers in developing countries to attract more foreign capital. Most countries have reduced barriers to FDI and many aggressively offered tax incentives and subsidies, believing that FDI promotes growth.

In theory, there are several potential ways in which FDI can promote economic growth. For example, Solow-type standard neoclassical growth models suggest that FDI increases the capital stock and thus growth in the host economy by

* Corresponding author. Tel.: +49 69 798 23535; fax: +49 69 789 28121.
E-mail address: DierkHerzer@gmx.de (D. Herzer).

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financing capital formation (Brems, 1970). Admittedly, in neoclassical growth models with diminishing returns to capital, FDI has only a 'short-run' growth effect as countries move towards a new steady state. Accordingly, the impact of FDI on growth is identical to that of domestic investment. In contrast, in endogenous growth models, FDI is generally assumed to be more productive than domestic investment, since FDI encourages the incorporation of new technologies in the production function of the host economy (Borensztein et al., 1998). In this view, FDI-related technological spillovers offset the effects of diminishing returns to capital and keep the economy on a long-term growth path. Moreover, endogenous growth models imply that FDI can promote long-run growth by augmenting the existing stock of knowledge in the host economy through labour training and skill acquisition, on the one hand, and through the introduction of alternative management practices and organisational arrangements on the other (see, e.g. De Mello, 1997).[1] Thus, through capital accumulation and knowledge spillovers, FDI may play an important role for economic growth.

Although the positive impact of FDI on economic growth seems to have recently acquired the status of a stylised fact (Campos and Kinoshita, 2002), a careful reading of the literature suggests that this positive relationship is far less definitive than generally believed. Agosin and Mayer (2000), for example, argue that FDI in the form of mergers and acquisitions do not necessarily increase the capital stock in capital-scarce economies. Cross-border mergers and acquisitions merely represent a transfer of existing assets from domestic to foreign hands. If the proceeds of the sales of these assets are spent on consumption, FDI does not contribute to capital formation and growth.[2] More importantly, the positive effect of FDI on growth through capital accumulation requires that FDI does not 'crowd out' equal amounts of investment from domestic sources. Accordingly, FDI may actually harm the host economy when foreign investors claim scarce resources, such as import licenses, skilled manpower, credit facilities, etc., or foreclose investment opportunities for local investors.

In addition, there is also concern that the positive knowledge spillovers predicted by endogenous growth models do not occur in developing countries. For instance, Görg and Greenaway (2004) critically review a number of firm-level studies on productivity spillovers in manufacturing industries in developing, developed and transition economies. They report that only six of 25 studies using appropriate data and estimation techniques find some positive evidence of spillovers running from foreign-owned to domestic-owned firms, none of which is for developing countries. One of these 25 – namely that by Aitken and Harrison (1999) for Venezuela – actually find some evidence of negative effects of the presence of multinationals firms.

Several reasons have been offered to explain these negative or statistically insignificant results. The most plausible explanation for the negative effects is that foreign firms reduce the productivity of domestic firms through competition effects, as suggested by Aitken and Harrison (1999). They argue that multinationals have lower marginal costs due to some firm-specific advantage, which allows them to attract demand away from domestic firms, forcing them to reduce their production and move up their average cost curve. Furthermore, FDI is often associated with firm restructuring to integrate the target firm into the production chain of the multinational company, which implies that raw materials and other inputs are purchased within the multinational enterprise and thus from foreign rather than local suppliers.

There are also reasons for a failure to find any evidence for positive spillovers. For example, multinationals may be able to effectively protect their firm-specific knowledge (Görg and Greenaway, 2004). Moreover, domestic firms using very backward production technology and low-skilled workers may be unable to learn from multinationals. Finally, knowledge spillovers are realised only if local firms have the ability to invest in absorbing foreign technologies, which may be restricted by underdeveloped local financial markets.[3]

Despite these potential negative effects, the empirical evidence generally suggests that FDI has a positive impact on economic growth in developing countries, as recent surveys by Lim (2001) and Hansen and Rand (2006) attest. The existence and size of the impact of FDI on growth seems to depend, however, on economic and political conditions in the host country, such as the level of per capita income, the human capital base, the degree of openness in the economy and the extent of the development of domestic financial markets.

In this paper, we call this finding into question first, by pointing to problems in the current empirical literature and, second, by undertaking our own empirical assessment where we find little support for the growth-enhancing effect of

[1] In this context it is also argued that multinational companies, through FDI, may also diffuse their knowledge of global markets to domestic firms and thus enable them to become more successful exporters.

[2] This might be of particular relevance for many Latin American countries where a significant share of FDI flows in the 1990s occurred as a result of privatisation of state-owned enterprises.

[3] In addition to concerns that positive spillovers and capital accumulation effects do not occur in developing countries, some authors have raised concerns about possible balance of payments problems due to the repatriation of profits by foreign investors (Seabra and Flach, 2005) and harmful environmental impacts, if multinationals use FDI to 'export' production no longer approved in their home countries (Wheeler, 2001).