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Less compelling than it seems: rethinking the relationship between aggregate FDI inflows and national competitiveness

by

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Following the release of the OECD's updated foreign direct investment (FDI) statistics, the United Kingdom (UK) government proudly announced in June 2015 that "[t]he UK has maintained its position as the number one destination for FDI in Europe," and then Prime Minister David Cameron explained that "[t]he scale of foreign investment is a huge success story which shows that Britain is the place to do business and is further evidence that our long-term economic plan is working". [1] Such interpretations of aggregate FDI data as an indicator of countries' general economic performance are widespread in today's economic policy debates. They derive in part from a widely held and largely unquestioned assumption that FDI inflows are intimately connected to a country's level of "competitiveness".

Although there are other uses of the term, the most common understanding of the notion of national competitiveness as the quality of a country's business environment has been shaped by the extraordinarily influential work of Michael Porter[2] who defined it as being essentially determined by the level of productivity of a national economy relative to its peers. Following this view, the connection between FDI inflows and competitiveness made in policy discourses thus appears to assume that FDI inflows are either a *cause* or an *outcome*—or both—of a highly productive business environment. This *Perspective* aims to show that this connection is in fact not as straightforward as it might seem.

Conceptually, it is important to distinguish between three distinct types of FDI flows: greenfield investments, mergers and acquisitions (M&As) and special purpose entity (SPE) FDI. I argue that only a subset of these different types of FDI flows are related to national competitiveness in a meaningful way—and even in the cases where they are related, the relationship is always conditional.

The claim that FDI inflows are a cause of economic competitiveness is based on the intuitively compelling idea that investment by internationally competitive multinational enterprises (MNEs) improves productivity in host economies because it brings technology, managerial skills and access to international markets—factors that are particularly important for developing economies—as well as research-and-development (R&D) activities and high-value-adding employment that are particularly desired by policymakers in advanced economies. This relationship is unlikely to hold for SPE FDI, which normally does not imply any real industrial activity in the host economy. It can be true for either greenfield or M&A FDI, but empirical studies have repeatedly highlighted that the positive spillover dynamics frequently ascribed to inward FDI are in fact highly context-specific, depending both on the nature of the FDI projects and the absorptive capacities of the host economies, and should thus not be taken for granted.[3]

The claim that FDI inflows are an outcome of economic competitiveness is based on the idea that global capital is "footloose" and freely moves to places that offer the most attractive business environment. As a result, it is frequently implied that the whereabouts of FDI inflows are an indicator of the competitiveness of national economies. Such notions also have to be qualified. While they might be correct for certain subsets of efficiency- and strategic assets-seeking greenfield and M&A FDI, these assumptions are unlikely to hold for a large number of FDI decisions. As is well known, an important share of greenfield and M&A FDI flows primarily seeks access to natural resources or consumer markets rather than the most productive economic environments. Moreover, M&A FDI may in some cases be attracted by the underperformance of local firms rather than their strength. In such scenarios, inward FDI may be a negative rather than a positive sign of competitiveness.[4] Lastly, SPE FDI flows are determined primarily by international tax considerations and are thus not related to industrial productivity in any meaningful way.

The policy implications of this are twofold. Firstly, FDI as such is not a simple proxy for a country's competitiveness, business environment or overall economic performance. Secondly, the quality of inward FDI is more important than its quantity. FDI quality cannot be assessed simply by looking at aggregate FDI statistics. To measure FDI quality, it is paramount to collect and analyze data at a more disaggregated level, including information on MNEs' operational details, such as the precise industrial activity, R&D expenditures, etc. Although the collection of better FDI data may be less rewarding politically than spending money to attract FDI, it is essential to assess the real connections between inward FDI and national competitiveness, which for now remain unclear.

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[1] UK Trade and Investment, "UK wins a record number of investment projects and maintains position as top investment destination in Europe," Press release (Jun. 17, 2015), available at

www.gov.uk/government/news/uk-wins-a-record-number-of-investment-projects-and-maintains-position-as-top-investment-destination-in-europe.

[2] Michael E. Porter, *The Competitive Advantage of Nations* (London: MacMillan, 1998).

[3] For an overview of this literature, see Klaus E. Meyer and Evis Sinani, "When and where does foreign direct investment generate positive spillovers? A meta-analysis," *Journal of International Business Studies*, vol. 40 (2009), pp. 1075-1094.

[4] Even if it is conceivable that such FDI flows subsequently improve the productivity of the target companies.

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