Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues

No. 242 December 31, 2018

Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)

Managing Editor: Marion A. Creach (marion.creach@sciencespo.fr)

How to leverage outward FDI for development? A six-step guide for policymakers[*]

by

Matthew Stephenson and Jose Ramon Perea[**]

Policymakers in developing countries increasingly realize that leveraging outward foreign direct investment (OFDI) helps advance development at home.[1] This *Perspective* proposes a framework to help policymakers tackle the new challenge of integrating OFDI into national development strategies.[2]

1. **Vision, strategy, restrictions**. Policymakers should identify economic development objectives to be supported through OFDI. The objectives (e.g., upgrading, innovation, exports, revenue, diversification) should determine how governments support OFDI. While OFDI can further multiple objectives, tradeoffs can require prioritization. OFDI rules and regulations may then need to be adjusted. Policymakers should also identify OFDI restrictions, weigh their costs and benefits and ensure that any restrictions retained serve sound policy goals and accomplish these at the least cost to the home economy.

2. **Non-financial support**. Market failures may inhibit OFDI. Many of them involve information asymmetries (e.g., a lack of domestic investors' knowledge about foreign market investment regulations or investment opportunities) that governments can help overcome. Non-financial support for OFDI can, therefore, take the form of market intelligence, investment missions, matchmaking services, and opening government offices in host economies to provide direct support for firms. Operationally, there are increasing opportunities for win-win collaborations between government offices promoting OFDI and investment promotion agencies seeking to attract inward FDI.

3. **Financial support**. Other forms of market failures relate to political risk and capital availability. For the former, policymakers in home economies should ensure that political risk insurance is available to mitigate non-commercial risk, whether provided by the private sector, the government or multilateral institutions, such as the World Bank Group's Multilateral Investment Guarantee Agency. As to capital availability, policymakers can consider the whole gamut of financial and fiscal measures, including:

- Grants, e.g., for feasibility studies, setting up firms' overseas offices and training, which are often critical for OFDI decisions;
- Loans, either concessional or non-concessional, to fill gaps left by commercial banks, either because target markets are too risky or because firms do not have collateral to secure loans;
- Guarantees, particularly important for SMEs' access to finance;
- Equity investment, whereby governments take minority stakes in OFDI ventures, leave management in operational control and allow it to buy out the governments; and
- Fiscal measures, such as OFDI being exempted from the tax base, or lower tax rates on OFDI profits.

Importantly, financial and fiscal measures should be used where needed to support profitable and beneficial investments that would not otherwise take place, and not simply to subsidize OFDI. Leading economies have put in place clear guidelines to minimize this risk, such as paying only a portion of costs, not upfront but through reimbursements—to third parties—, and requiring risk-sharing through firms having "skin in the game."

4. **Barriers to entry**. Policymakers also have a role to play in opening markets that are closed. This can include negotiating treaties and improvements in market access. The current trade and investment dispute between the US and China could be partly seen as a negotiation over barriers to entry for OFDI from western economies into the Chinese market, given issues related to market-access reciprocity. Chambers of commerce and other business associations should bring to the attention of policymakers both *de jure* and *de facto* barriers to OFDI for government-to-government commercial diplomacy to take place, in a manner complementary to traditional business advocacy.

5. **Operational support**. Even after creating an enabling environment for OFDI through information, finance and market access, policymakers need to provide operational support. This can include information on new market opportunities after overcoming entry barriers and troubleshooting when there are issues with investments. One example is implementing early-warning mechanisms in host countries to address foreign investor complaints before they escalate into formal legal disputes. Other examples include encouraging legal and accounting professionals in home countries to provide *in situ* support for OFDI deals, strengthening the legal infrastructure to provide greater protection for OFDI (such as joining the International Centre for Settlement of Investment Disputes, as Mexico just did) to arbitrate OFDI-related disputes, and supporting OFDI by groups of companies, something that some East Asian economies pioneered a few decades ago, and that policymakers in other countries are increasingly copying.

6. **Maximizing benefits**. FDI can lead to significant benefits for home economies.[3] Some of these are direct, while some are indirect, or result from spillovers. Policymakers should boost the absorptive capacity of home economies to maximize OFDI's benefits, especially by creating linkages between OFDI firms and other domestic firms, to diffuse capacities acquired abroad throughout home economies. Fostering such linkages includes

encouraging consortium bidding for OFDI projects (as Poland and Singapore do), whereby the larger firms in the consortium bring along the smaller firms. In addition, policymakers should adopt monitoring and evaluation frameworks to ensure that home-country measures accomplish their intended effects and are cost effective.

Finally, inward FDI, OFDI and exports are often related,[4] suggesting that policymakers should consider leveraging them in unison, e.g., by ensuring overlap in target sectors. By so doing, along with the six steps outlined above, OFDI can increasingly serve as a complementary channel to help drive home-country development.

---

[*] **The *Columbia FDI Perspectives* are a forum for public debate. The views expressed by the author(s) do not reflect the opinions of CCSI or Columbia University or our partners and supporters. *Columbia FDI Perspectives* (ISSN 2158-3579) is a peer-reviewed series.**

[**] Matthew Stephenson (matthew.stephenson@graduateinstitute.ch) is a researcher at the Graduate Institute of International and Development Studies, Geneva, and a consultant to the World Bank Group; Jose Ramon Perea (jrperea@worldbank.org) is a senior economist with the World Bank Group's Macroeconomics, Trade and Investment Global Practice. This *Perspective* is based on Matthew Stephenson, "OFDI and development: policy considerations to leverage a new pathway for growth," in Syed Munir Khasru, ed., *Towards Sustainable Development: Lessons from MDGs & Pathways for SDGs* (Bangladesh: IPAG, 2017), pp. 367-386, and Jose Ramon Perea and Matthew Stephenson, "Outward FDI from developing countries," in World Bank, *Global Investment Competitiveness Report 2017/2018* (Washington, DC: World Bank, 2017), pp. 101-134. The authors are grateful to Thomas Biersteker, Klaus Meyer and Ravi Ramamurti for their helpful peer reviews.

[1] See, Karl P. Sauvant, "A new challenge for emerging markets: the need to develop an outward FDI policy," *Columbia FDI Perspective*, no. 203, July 3, 2017.

[2] For a review of concrete measures taken by 20 leading home economies, see Karl P. Sauvant et al., "Trends in FDI, home country measures and competitive neutrality," in *Yearbook on International Investment Law & Policy 2012-2013* (New York: OUP, 2014), pp. 3-107.

[3] Jan Knoerich, "Do developing countries benefit from outward FDI?", *Columbia FDI Perspective*, no. 234, September 10, 2018.

[4] Shujie Yao et al. "Dynamic relationship between China's inward and outward foreign direct investments," *China Economic Review*, vol. 40 (2016), pp. 54-70; Robert E. Lipsey, Eric Ramstetter and Magnus Blomström. "Outward FDI and parent exports and employment: Japan, the United States, and Sweden," *Global Economy Quarterly*, vol. 1 (2000), pp. 285-302; Torfinn, Harding and Beata S. Javorcik, "Foreign direct investment and export upgrading," *Review of Economics and Statistics*, vol. 94 (2012), pp. 964-980.

For further information, including information regarding submission to the *Perspectives*, please contact: Columbia Center on Sustainable Investment, Marion A. Creach, marion.creach@sciencespo.fr.

The Columbia Center on Sustainable Investment (CCSI), a joint center of Columbia Law School and the Earth Institute at Columbia University, is a leading applied research center and forum dedicated to the study, practice and discussion of sustainable international investment. Our mission is to develop and disseminate practical approaches and solutions, as well as to analyze topical policy-oriented issues, in order to maximize the impact of international investment for sustainable development. The Center undertakes its mission through interdisciplinary research, advisory projects, multi-stakeholder dialogue, educational programs, and the development of resources and tools. For more information, visit us at http://www.ccsi.columbia.edu.

Most recent *Columbia FDI Perspectives*

- No. 241, Robert W. Schwieder, "Lessons for a future advisory center on international investment law," December 17, 2018
- No. 240, Felipe Hees, Henrique Choer Moraes, Pedro Mendonça Cavalcante, and Pedro Barreto da Rocha Paranhos, "Investment facilitation: leaving the past behind," December 3, 2018
- No. 239, Joseph M. Wilde-Ramsing and Marian G. Ingrams, "High time for government action to make the OECD Guidelines a force for sustainable FDI," November 19, 2018
- No. 238, Andreas Tornaritis and Evi Neophytou, "Regional cooperation to enhance FDI in the development of offshore resources," November 5, 2018
- No. 237, Alvaro Cuervo-Cazurra, "Host country concerns and policies toward state-owned MNEs," October 22, 2018

All previous *FDI Perspectives* are available at http://ccsi.columbia.edu/publications/columbia-fdi- perspectives/.