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PAPER SERIES

Commemorative papers on the work of John H. Dunning

The papers appearing in this series are published for commemorating the life and work of the late Professor John H. Dunning. They are based on presentations given at a Fellows' plenary in Valencia, Spain at the annual meeting of the European International Business Academy (EIBA) in December 2009, but they have been substantially revised for publication here.

Locational determinants of outward foreign direct Investment: an analysis of Chinese and Indian greenfield investments

Filip De Beule and Daniel Van Den Bulcke*

Few scholars have contributed more to our understanding of the locational factors that influence the choices made by TNCs than John Dunning. According to him, the astonishing growth of the Chinese economy and the opening up of India to the demands of the global market place "are reconfiguring the spatial landscape of economic activity". The present study examines the importance of country-level factors on the investment location choice of Chinese and Indian transnational corporations (TNCs). Instead of using macro-economic FDI flows or stocks -- as most other studies have done -- this study will analyse greenfield investment data of Chinese and Indian firms across the globe. While most former studies have used FDI data to measure the aggregate value-adding activity of transnational affiliates in host countries, recent research has shown that the use of FDI data is a biased measure of such investment activity. This research attempts to overcome those shortcomings by analysing FDI at the firm level.

1. Introduction

In John Dunning's posthumously published book, *New Challenges for International Business Research: Back to the Future,* more particularly at the beginning of a chapter about the changing locational determinants of the activities of transnational corporations (TNCs), he wrote: "The last two decades have witnessed a number of dramatic changes in the location of international business (IB) activity and of our understanding of its determinants. Globalization, technological advances, the emergence of several new players on the world economic stage, and a new focus on the role of institutions and belief systems in the resource allocation process have been the main triggers for change" (Dunning, 2010: 93). Few scholars have contributed more to our understanding of the locational factors that influence the choices made by TNCs, while at the same time urging his colleagues to focus on the spatial dimensions and drivers of competitiveness both for

* Filip De Beule is Assistant Professor at Lessius University College, Belgium. Daniel Van Den Bulcke is Professor of International Management and Development at the University of Antwerp, Belgium.

companies and countries. According to John Dunning, the astonishing growth of the Chinese economy and the opening up of India to the demands of the global market place "are reconfiguring the spatial landscape of economic activity". In his retrospective thoughts on the occasion of the 2008 Decade Award of the Journal of International Business Studies, John Dunning listed "the emergence of so-called third-world TNCs – particularly those from Asia – as significant outward investors" (Dunning, 2009: 23) as one of the six far-reaching changes in the global economy that occurred since the 1990s. After a setback in the early 2000s, this movement regained strength – this time fuelled by the actions of Chinese and Indian firms.

Although most TNCs come from advanced countries, TNCs from emerging countries have made remarkable progress on the international investment scene in the last decade. Outward FDI from developing and emerging economies reached $328 billion in 2010, while six developing economies – including China and India – ranked among the top 20 investors (UNCTAD, 2011). In terms of destination, detailed data shows that sixty percent of the outward FDI flows from developing countries went into other developing countries, mostly in the form of greenfield investments (World Bank, 2011). UNCTAD's World Investment Prospects Survey 2011–2013 (WIPS) confirmed that developing economies are becoming important investors, and that this trend is likely to continue in the near future (UNCTAD, 2011).

Although some (Rugman and Li, 2007) have questioned that TNCs from emerging economies possess (sufficient) ownership advantages to expand successfully abroad, it seems that more and more firms from these emerging markets have gradually accumulated sufficient technological and other capabilities – also known as firm-specific advantages – to do so (van Agtmael, 2007; Wells, 1983). As a result, flows of outward FDI from emerging markets have increased significantly (Gammeltoft, 2008), demanding a closer look as to their characteristics and motivations (Child and Rodriguez, 2005).

As most research dealing with the location of outward foreign direct investment (FDI) has focused on outward investment from advanced economies, there are doubts about the applicability of those findings to the determinants that attract FDI from emerging markets. In the recent surge of emerging country TNCs as outward investors, China and India clearly are the most prominent actors. Although the expansion of cross-border investment by Indian and Chinese companies has caught the eye of researchers and pundits, the literature on the determining factors is still limited. Most research still focuses upon the analysis of inward FDI into India and, even more so into China. China and India are considered as belonging to the group of most cherished countries of destination for inward FDI (UNCTAD, 2011; Tolentino, 2008).

Although they seem to have the ambition to establish a world-class presence, the pattern of the outward expansion of Chinese and Indian TNCs is supposedly different to that of their developed-world competitors. Research (e.g. Guillèn and Garcia-Canal, 2009) has shown that emerging country TNCs sometimes demonstrate a different investment behaviour from their developed country counterparts. Many TNCs from emerging economies are concentrating their investments in other developing markets because these markets supposedly are more responsive to the experience gained in their home markets. As TNCs from developing countries have developed capabilities that allow them to successfully deal with the configurations of the customers and suppliers in their domestic markets, these same abilities subsequently provide them with an advantage over TNCs from advanced countries when expanding into other developing countries with similar conditions and characteristics.

Although these emerging country TNCs seem to follow a different pattern of internationalization, John Dunning believed "it is possible to formulate a general paradigm of MNE activity which sets out a conceptual framework and seeks to identify clusters of variables relevant to an explanation of all kinds of foreign owned output" (Dunning, 1993: 68). When assessing the motivations that determine the internationalization patterns of emerging country TNCs, several researchers have indeed identified clusters of determinants that explain much of their behaviour (Buckley et al., 2007; Poncet, 2007; Duanmu and Guney, 2009; Pradhan, 2009, 2011; Hay et al., 2011a; De Beule and Duanmu, 2012). In general, their conclusion is that these TNCs carry out market-seeking, natural-resource-seeking or strategic-asset-seeking investments. However, other researchers remarked that these determinants do not fully capture the phenomenon and do not explain all activities and motivations of Chinese and Indian TNCs (Child and Rodriguez, 2005).

To respond to this research gap, the present study contributes to the literature by examining the importance of country-level factors on the investment location choice of Chinese and Indian TNCs, more specifically by concentrating on greenfield establishments. Instead of using macro-economic FDI flows or stocks – as most other studies have done – this study will analyse greenfield investment data of Chinese and Indian firms across the globe. While most former studies have used FDI figures to measure the aggregate value-adding activity of transnational affiliates in host countries, recent research (Beugelsdijk et al., 2011) has shown that the use of FDI data is a biased measure of such investment activity. This research attempts to overcome those shortcomings by analysing FDI at the firm level.

While briefly looking at the development of the eclectic or OLI paradigm, this article first analyses the (re)appearance of location in international business research, as stressed by John Dunning's influential contributions during the last few decades. Next, it tackles the importance of Dunning's eclectic framework in terms of outward FDI. Consequently, the differences and similarities with respect to location and outward FDI policy between developed and developing countries are discussed. In particular, the locational determinants of outward FDI of Chinese and Indian TNCs are dealt with. On the basis of macroeconomic determinants, it will be attempted to ascertain the relevant host-country factors that drive the locational choices of greenfield investment of Chinese and Indian firms, as well as the similarities and differences between these two countries. The article will end with some conclusions, in which a comparison will be made with the findings of two other recent studies about Chinese and Indian outward investment (Hay et al., 2011a; Pradhan, 2011). Even though these latter papers rely on a different database and another methodology, such a comparison may be useful, especially because more or less the same period is being considered.

2. Dunning and location

Already in his early academic career, John H. Dunning took a keen interest in the concept of location. His first major research project in

1952 was to analyse radio and TV companies in the United Kingdom wishing to expand their activities in England's prosperous South East and Midlands regions, and comparing them with those manufacturing firms setting up plants in the so-called Development Areas of that time such as Wales, Scotland and the North of England (Dunning, 2009). While studying relative manufacturing costs, he uncovered the key role of locational factors that influenced those costs. He specifically found that the lower costs in wages, materials, utilities and other production activities of running a branch plant in these Development Areas outweighed the additional transaction costs of establishing in those less attractive regions (Hague and Dunning 1954; Dunning, 2009). According to his biography, John Dunning thought that his first exercise in location economics set the tone for the rest of his career as he wrote: "I did not appreciate it at the time, but this particular research project was to prove an excellent training ground for the kind of scholarly work I have pursued most of my professional life" (Dunning, 2008a: 62).

During this early research John Dunning had observed quite a few subsidiaries of United States TNCs in the light engineering industries, of which many were located in Scotland. Consequently he decided to study United States TNCs' manufacturing subsidiaries in the United Kingdom in more detail to find out what determined their activities and performance. In his seminal 1958 book, *American investment in British manufacturing industry*, which was published again four decades later in 1998, he provided information not only about the size and distribution of the American industrial presence of those firms, but also about their organizational structure and decision making, as well as their contribution to industrial productivity and consumer welfare in the UK. He found that American firms' labour productivity in their home country was higher than in comparable British-owned companies. Also, when operating in Britain, the subsidiaries and branches of those American groups proved to enjoy higher levels of productivity than the UK firms in the same sectors, even though they did not reach the level achieved by the parent companies in the US (Corley, 2010). Based on these findings John Dunning made a distinction between what he called the location (L) of production effect and the ownership (O) of nationality effect. He chose this latter term to reflect a firm's possession of advantages gained from factor endowments, economies of scale, and so on. Only later did his analysis of ownership advantages begin to focus more on the created assets of firms, such as technological advances and brands.

John Dunning combined these advantages he had identified before into what he called an "eclectic theory of international production" and presented his views for the first time during a Nobel Symposium in 1976. His theory, which he later renamed a paradigm, included not only his two earlier terms of ownership (O) and location (L) advantages, but also the concept of internalization advantages (I) as analysed by Buckley and Casson (1976) and Hennart (1982). The eclectic paradigm is also referred to as the OLI model of international investment. TNCs would determine the extent of their foreign assets according to how best they could internalize their ownership and location advantages in a hierarchal structure rather than relying on the market approach based on for instance exports or licensing. The eclectic paradigm was extended several times to accommodate evolving international business trends and realities, such as the expansion of the service industry and the increasing reliance on strategic alliances by TNCs (Dunning, 1995: 2000). One of the latest additions or qualifications that Dunning made to the OLI paradigm was to include institutional theory (Dunning, 2006) in the choice of the location advantage variables. This is consistent with the fact that – although scholars concentrated initially on factor endowments, especially labour costs and productivity – TNCs have increasingly focused on created assets, including knowledge-based assets, infrastructure and institutions of the host economy. In this respect, Dunning pointed out the significance of the content and quality of a country's social capital, its environmental integrity, its policies towards bribery and corruption, its acceptance of the need for transparent and accurate information, and the respect of the business organization for the law, particularly in relation to the enforcement of inter-firm contracts (Dunning, 2009).

Although Dunning always maintained throughout his career that spatial issues are the life and blood of international business scholarship (Dunning, 2009), in general, during the 1980s, both the international business scholars who were economists as well as the strategists tended to somewhat downplay the L factor in their studies of the determinants of FDI and transnational activity and were primarily concerned with the internal workings of TNCs. Yet, when Michael Porter (1994) stressed the importance of location as a competitive enhancing advantage of firms, he gave pride of place to location again. In essence, Dunning (1998) consequently argued that the unfolding events of the 1990s were demanding a careful reappraisal of the L component of the

OLI paradigm; and how this affected both received scholarly thinking, and the interface between the locational choices and competitive advantages of both firms and countries (Dunning, 2009).

John Dunning very early on recognized that physical or geographic distance became less important for international trade and global investment decisions because of the falling costs as a result of technical and organizational developments and advances in the transport and communication sectors. Therefore he put more emphasis on the cultural, psychic and institutional distance across national borders. "This obviously places locations, which are institutionally distanced from each other, or firms not willing or capable to overcome such distance, at a disadvantage" (Dunning, 2010: 108). This dimension may be especially relevant for firms from emerging economies.

3. Developed versus emerging economies' outward FDI policies

Although much analysis has focused on the determinants of investment attraction, not only inward FDI patterns but also patterns of outward FDI reflect the particular institutional and policy context in which the investing firms have evolved and developed their ownership advantages (Dunning, 2009). For instance, corporate decisions are affected by the legal framework governing international capital flows, as well as by proactive policy measures to assist companies in their internationalization process (UNCTAD, 2006).

During the 1960s and 1970s, most governments in developed countries were not proactive in promoting outward FDI. In fact, outward investment was opposed in many home countries as it was seen as substituting for exports, reducing domestic capital investment and causing the loss of jobs. Yet it was also defended to guarantee the growth and prosperity of home-based firms in the contest for worldwide markets. Outward FDI therefore became gradually accepted as a necessary means to maintain and improve the competitiveness of firms from the countries of origin by exposing them to international markets via direct investment (De Beule and Van Den Bulcke, 2010a).

Increasingly, moreover, attention shifted from the macroeconomic impact to microeconomic significance. In a rapidly globalizing world, companies could no longer merely count on their home markets as a relatively secure source of profits (UNCTAD, 2007). Competition from foreign firms became global through imports, inward FDI and non-equity forms of participation. These various exposures and conditions made it all the more important for firms to pay attention to their competitiveness (Sauvant, 2005). For integrating developing country firms into the global economy, outward FDI became an important aspect and vehicle of this consideration. The fact that small and medium sized firms are also expanding abroad by outward FDI and that more countries are encouraging their firms to do so indirectly demonstrate that the benefits of internationalization for increasing firm competitiveness became generally recognized. In particular, outward FDI can help firms increase their revenues, assets, profitability, market reach, and exports (UNCTAD, 2007).

After the Second World War, when developed countries had to cope with the urge of some of their companies to invest abroad, they only hesitantly allowed this because of the uncertainty about their future balance of payments developments and the shortages of foreign exchange. To achieve a balance between the need to "control" cross-border capital outflows and the pressure for firms to internationalize was therefore of paramount importance. Once the macroeconomic concerns had receded at the beginning of the 1970s, most of the developed countries rather quickly removed these restrictions, even though employment concerns prompted calls for a revival of outward FDI controls in countries such as the United States (e.g. the Burke-Hartke proposal in the United States Congress).

While some developed countries retained only a few restrictions that were applicable during the 1970s (UNCTAD, 1995), changes in the world economic conditions and the evolving nature and expansion of TNCs transformed the attitudes and policies of the governments of emerging economies towards outward FDI. The globalization of the financial markets and the integration of the value added activities across national borders made international competition more severe. These mounting competitive pressures convinced a number of emerging countries that outward FDI had become a necessary strategic option to acquire access to resources abroad such as raw materials, energy, skilled labour, as well as technology and know-how. The so-called "Asian Tigers" from South-East Asia were among the first developing economies to liberalize and to start promoting outward FDI. Improvements in the balance of payments of countries and the build-up of foreign exchange reserves often were necessary but not sufficient conditions for governments to re-evaluate their outward FDI policy.

For the economies of South East Asia, this policy change took place in the second half of the 1980s and early 1990s, that is, Singapore in 1986, Taiwan Province of China and the Republic of Korea in 1987, Malaysia and Thailand in 1991. China and India gave a new impetus to their outward FDI policy from 1992 onwards, while Chile eliminated most of its restrictions on outward investment in 1991, and South African firms could engage more easily in outward FDI after the relaxation of the sanctions imposed by the rest of the world at the end of the apartheid policy in 1990 (De Beule and Van Den Bulcke, 2010a).

During the 1960s and 1970s, developed countries used a number of direct or indirect measures to stimulate their enterprises to venture abroad via outward FDI. Essentially, emerging markets, during the 1990s and the first decade of the new millennium, relied on the same kind of measures, although there were differences in the intensity with which they were applied. For instance, emerging economies provided incentives to outward FDI long before most controls on inward FDI had been suspended. They also started promoting outward FDI well before they had reached the supposedly required stage in the so-called "investment development path" as put forward by Dunning (1981). Also, the existence of direct links between the government and business in several emerging markets – such as China and Singapore – gives a special dimension to the promotional programmes and makes it difficult to disentangle the real influence that is exerted on their outward FDI policy.

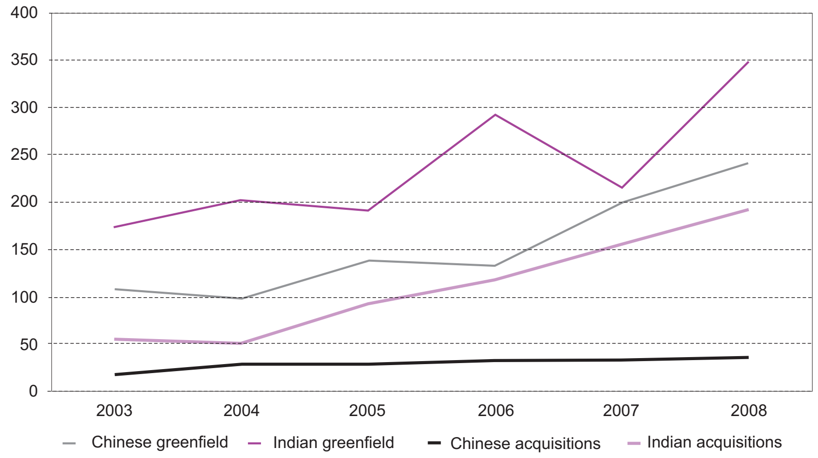
The impact of outward FDI on the home country illustrates another marked difference in the comparison and assessment of outward FDI between developed and emerging economies. While the loss of employment was a very serious concern in developed countries during the 1970s, it is somewhat surprising that this issue is not all that prominent in the discussion about the attitudes of developing countries towards outward FDI. This may be due to several reasons. First, this might be explained by the absence of strong trade unions in developing countries. During the 1970s, especially in the U.S., but also in the European countries with high rates of trade union membership, the opposition to outward investment was based on fear of permanent job losses and de-industrialization of the economy. Meanwhile, it has been accepted that outward FDI does not necessarily lead to unemployment when the core activities are retained at the parent company in the country of origin, or when exporting is not sufficient to maintain foreign market shares because of the competitive strengths of the local firms. Secondly, to the extent that outward investment from developing countries is resource seeking and strategic asset seeking, the employment effects may be negligible. Thirdly, as developing countries still find themselves relatively cost-competitive when compared to developed countries, there is less risk of relocation by efficiency-seeking divestment. This is so because developing countries are increasingly joining the ranks of outward investors at an earlier stage of development (De Beule and Van Den Bulcke, 2010a).

In terms of the impact on exports, much of the outward investment is trade creating instead of trade diverting. Most of these emerging countries still find themselves in the "Japanese" phase of their development process (Kojima and Ozawa, 1984). Most investments are made in trade-supporting market-seeking activities or take place in export-oriented resource-seeking initiatives, although they also focus upon the acquisition of strategic assets, such as knowledge and brands. These emerging country TNCs seem to be using these acquisitions as a way to springboard the acquired companies and products to their domestic markets (Fleury and Fleury, 2011). Despite the increasing number of acquisitions that Chinese and Indian firms are carrying out, we will focus on greenfield investments as it is rather the location of firm-specific advantages of target firms rather than country-specific advantages that is most likely to determine a firm's choice of acquisitions – even though these former advantages may reflect at least partially their country of origin (Dunning, 2009).

4. Locational determinants of foreign greenfield investments by Chinese and Indian firms

In order to test Dunning's framework of locational drivers to inward and outward FDI, we intend to analyse the geographical pattern and determinants of greenfield investments of Chinese and Indian firms abroad. Besides, despite the perception of the opposite that, for instance, China is buying up the world (Economist, 2011), greenfield investments clearly outnumber acquisitions during the period under investigation. Figure 1 shows that greenfield investments outrank the number of acquisitions for both China and India. The figure also indicates that India outnumbers China in both the number of acquisitions as in the number of greenfield investments. Both, however, illustrate a positive trend over time.

Figure 1. Number of Chinese and Indian greenfield investments and acquisitions, 2003-2008.



Source: **Authors' calculations based on fDi and Zephyr databases.**

Dunning suggested that institutions, markets, resources and capabilities (I, M, R and C) are the main ingredients of the competitiveness of national economies, the quality of which determine the value of inward FDI by foreign companies and the outward FDI of their TNCs (Dunning and Zhang, 2008). This is in line with existing literature (Deng, 2004; Kaartemo, 2007; Pradhan, 2009) which has indicated that Chinese and Indian TNCs are motivated by host country characteristics such as market potential, institutional environment, and access to natural resources and intangible assets. These characteristics will be included in the following analysis about the determinants of Chinese and Indian FDI.

4.1 Locational determinants

Institutional distance

Bloningen (2005) indicated that the quality of the institutional environment is an important determinant for attracting FDI, especially for less developed countries. Baniak et al. (2003) suggested that macroeconomic and institutional inefficiency of the host country has a negative effect on FDI. Groh and Wich (2009) showed the importance of political and legal systems of a host country for inviting foreign investors, while Naudé and Krugell (2007) stressed specifically that legislation and regulatory quality are important determinants for FDI. Next to legal and political systems, corruption is often seen as an important proxy for the quality of the business environment of a host country. Bénassy-Quéré et al. (2007) showed that corruption impacts negatively on FDI, while Wei (2000) stressed that corruption influences both the volume as well as the distribution of investment capital. Cuervo-Cazurra (2006) found that corruption results in lower outward FDI flows from OECD countries, but noticed higher FDI outflows from countries that themselves registered a high level of corruption.

In fact, as developing countries tend to have less advanced market-supporting institutions, regulatory quality and control of corruption are often weak. Furthermore, there is likely to be a lack of effective law enforcement, reliable information systems and efficient market intermediaries. To operate successfully at home, emerging country TNCs therefore need to create non-market resources to compensate for these institutional voids (Cuervo-Cazurra and Genc, 2011; Khanna and Palepu, 2006; Dunning and Lundan, 2008a; Van Assche, 2011). These non-market resources subsequently provide Emerging country TNCs with an advantage over Advanced country TNCs when internationalizing into other developing countries with similarly weak institutional environments (Khanna and Palepu, 2006; Cuervo-Cazurra and Genc, 2008, 2009, 2011). Therefore, the institutional differences of host countries impact their relative attractiveness to foreign investors. Institutional distance is likely to deter FDI, however (Dunning, 2009).

Hypothesis 1: A lower institutional distance between the home and host country encourages FDI from Chinese and Indian investors.

Income difference

Besides dealing with weaker market-supporting institutions, Emerging country TNCs also take into account the lower and different purchasing powers, lifestyles and preferences of the consumers in their home market compared to characteristics in the advanced markets (Van Assche, 2011). By specializing in products and services that are more in line with the preferences of their home-country consumers, Emerging country TNCs can successfully compete with Advanced country TNCs in their home market (Prahalad and Lieberthal, 1998; Gadiesh, Leung and Vestring, 2007). These market-based resources subsequently also provide Emerging country TNCs with an advantage in other developing countries with similar consumer segments, and comparable market specialization patterns (Lall, 1983; Hu, 1995; Dawar and Frost, 1999; Van Assche, 2011).

Many Chinese and Indian firms are said to have invested internationally in order to access and develop new markets, as their local markets have become increasingly competitive. Also domestic growth is often constrained by an underperforming distribution network, market saturation and regional market protection within the country (Voss, 2011; Pradhan, 2011). As such, it is argued (Wells, 1983; Lecraw, 1993) that developing country firms generally tend to invest in other less developed countries as the investing firms can rely on their firm-specific advantages which are better adapted to the needs and preferences existing in other developing countries.

Hypothesis 2: A smaller income difference between the home and host country encourages FDI from Chinese and Indian investors.

Natural resources

A third set of investment motives are linked to the availability of natural resources, such as metals, minerals and oil. Transaction cost theory suggests that companies engage in upstream vertical integration investment to exploit local natural resources as inputs in the production process in home or overseas markets (Dunning, 1979). TNCs from emerging economies engage in natural-resource-seeking FDI due to the increased demand for their products both at home and abroad. They also prefer to integrate vertically into raw materials supply because of the rising prices of commodities. Besides they quickly realized that a steady supply of inputs at stable prices is essential to their production processes (Anwar et al., 2008; UNCTAD, 2005). Buckley, et al. (2007) showed that natural resources play a positive and significant role in the attraction of Chinese FDI. Given that China is considered to be "the factory of the world" while India is more focused on services, this factor is likely to be less important for India than for China.

Hypothesis 3: Host countries with a high natural resource export propensity are more likely to attract Chinese and Indian direct investment.

Strategic assets

Strategic assets also form an important investment motivation for Chinese and Indian investors (Athreye and Kapur, 2009). Intellectual properties such as patents and trademarks are the typical strategic assets that firms crave, as technological and marketing advantages are critical factors for companies to compete successfully in foreign markets. These advantages are of primordial importance for industries that depend to a large extent on design and/or innovation, like electronics, ICT, pharmaceuticals, machinery and transportation equipment (UNCTAD, 2006). It is in these industries that the Chinese and Indian TNCs are indeed making inroads.

Given the sectoral distribution of Chinese and Indian outward FDI, strategic-asset-seeking investment behaviour is supposed to be of significance to explain their spreading out to other countries. Some researchers (Pradhan, 2011) argue that Indian firms possess more proprietary technological assets than their Chinese counterparts. Chinese companies are considered, however, to be more dependent upon their foreign partners for knowledge and expertise. Although a number of emerging Chinese TNCs have been able to take up a leading international position in innovative goods, they are often perceived as imitators of successful products developed elsewhere (Mathews, 2006). In general, however, both Chinese and Indian firms are more likely to seek out countries which have a better track record of intellectual property creation in order to benefit directly or indirectly from the transfer of technology and know-how.

Hypothesis 4: Host countries with a higher level of intellectual property are likely to attract more Chinese and Indian direct investors.

Other control variables

Other control variables that are generally used in literature are added to the gravity model used in the analysis. A substantial research body has illustrated the positive relationship between market size and investment attraction. Most research about advanced country TNCs indicates that market-seeking behaviour targets large markets, generally measured by gross domestic product (GDP) or population (POP) of the country. Regional economic integration can furthermore enlarge the market size of countries and upgrade the member countries in such an integrated zone into highly attractive destinations for TNCs because the access extends to the markets of all the participating nations (UNCTAD, 2006; Geppert et al., 2005). Such integrated enlarged markets generate positive externalities and increase the attractiveness of member countries to inward FDI (Barrell and Pain, 1998). After investing in one country, companies also benefit from free export access to the other member countries. Therefore, economies that are open to international trade seem to attract more FDI than less open economies. Yet, some studies conclude that (non-)tariff barriers deter trade, but boost companies to invest abroad in order to leap over the tariff walls as was often the case for United States and Japanese firms that sought to be inside the European Union because of the introduction of the common external tariff (Caves, 1996; Moran, 1998).

The Chinese and Indian economies are quintessential examples of the importance of market liberalization on direct investment for emerging economies. The Chinese and Indian markets initially incited little or no interest from foreign investors until they liberalized their economies. Kumar (2001) found a positive connection between market openness and FDI in both modern and traditional industries. When international trade is less restricted, components, parts and semi-finished products can be imported more easily and at lower prices. Most researchers therefore concluded that there is a positive relationship between market openness and FDI (Chakrabati, 2001; Gastanaga et al., 1998; Lall, 1996). Chinese firms also typically establish an export facilitating platform in a third country which faces less or no trade restrictions for the specific products (Wall, 1999; De Beule, et al., 2010).

Finally, given that the analysis relies on a gravity model, it has to be acknowledged that distance also impacts on the investment decision as most firms still prefer to invest in countries within the existing regional network of headquarters. Various distance measures can be included, such as geographical distance, but also a common colonial heritage may play a role.

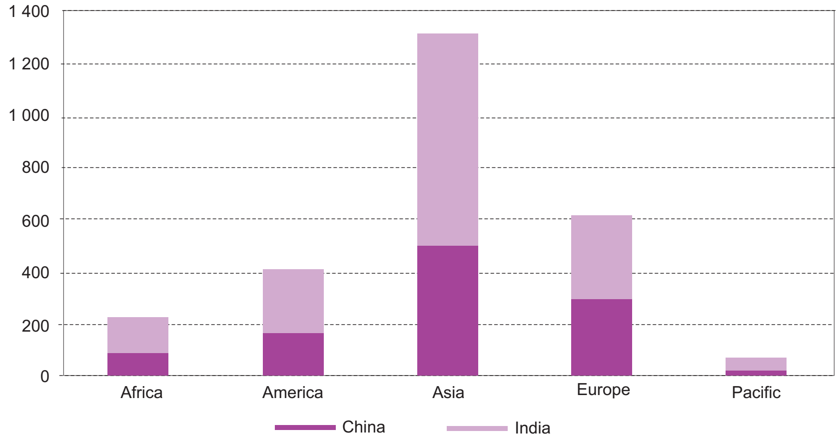
4.2. Data and methodology

Data description

Data for Chinese and Indian direct investment projects were drawn from the fDi Markets database (FT, 2011), which tracks greenfield investment projects. It does not include M&A or other equity-based or non-equity investments. The database consists exclusively of new investment projects and significant expansions of existing FDI projects. The data presented here cover FDI projects that have been launched by a company during the period 2003 through 2008. Because TNCs can raise capital locally, phase their investment over a period of time, and channel their investment through different countries for tax purposes, the data used in this article are different from the official data on FDI flows. The dependent variable will be constructed through the number of greenfield investments rather than the value. Given that the value of some very large investments might skew the results, the number of projects is preferred (Agrawal and Sensarma, 2007).

Figure 2 shows the internationalization of Chinese and Indian firms across the globe and their growing number of investments over time. Although Indian investors systematically outnumber Chinese investors for in terms of greenfield projects, both countries show a significantly positive trend over time. The distribution across regions shows that, of the 1071 Chinese and 1578 Indian investment projects in the database, Asia received the highest number, Europe takes a distant second place with about 600 projects, which is less than half the number of greenfield investments in Asia. The United States ranks third with about 400 projects while Africa has attracted around 200 projects. The Pacific region hosted the fewest number of greenfield projects. Figure 2 indicates that this orientation towards Asia and Europe is more pronounced for India than for China. This latter has a more balanced distribution of the number of greenfield projects among the different regions during the period 2003–2008.

Figure 2. Geographical distribution of greenfield investment projects for China and India, 2003–2008.



Source: **Authors' calculations based on fDi database, Financial Times (2011).**

Variable description

To measure institutional distance, the approach by Cuervo-Cazurra and Genc (2008) is followed by using various indicators of institutional quality, such as government effectiveness, political stability, rule of law, regulatory quality, and control of corruption. These indices capture the perception of the institutional quality (Van Assche, 2011). Institutional distance is then calculated as the difference in the level of these indices between the home and host country.

To measure income difference, the difference in a pair of countries' national income patterns is used. Emerging country TNCs may be better adapted to operate in countries with poorer customers. The knowledge and resources developed to serve customers who earn lower incomes are equally relevant and valuable in LDCs. Income distance is then calculated as the difference in the level of the gross domestic product per capita between the home and the host countries.

Natural resource seeking investors usually look for countries with large deposits of commodities like oil, minerals and ores in order to assure the steady supply of the needed raw materials (Athreye and Kapur, 2009). Given that the availability for export of these raw materials is essential, Duanmu and Guney (2009) calculated the percentage of ores and metal exports in total merchandise exports as a proxy for both the availability and accessibility to natural resources. We will add to this the importance of exports of oil. Chinese investments are clearly influenced by the presence of raw materials (Buckley et al., 2007; Cheung and Qian, 2008), but also Indian TNCs scurry to secure access to natural resources (Pradhan, 2009).

Given that firms from emerging economies like China and India have comparatively limited technological advantages that they can exploit, many Chinese and Indian TNCs are more focused on the absorption and advancement of technological expertise (Athreye and Kapur, 2009). Although research expenditures can be considered a reasonable proxy of innovative output in the absence of information on the actual innovations that firms have introduced, there are several drawbacks associated with the use of R&D spending, which is essentially an input in the innovation production function (see, for instance, Mairesse and Mohnen, 2002). In fact, not all innovations lead to the introduction of product or process innovations, i.e. it is possible that firms' efforts to innovate fail for some reason. By using R&D rather than actual innovations, there will be an overestimation of the innovative activities by such firms. Pradhan (2009) therefore suggests using patents as an indicator of the availability of strategic assets in a host country. However, technology is not the only intellectual property that Chinese and Indian firms crave; they also want to cultivate trademarks and designs which are important for brand recognition. The model will therefore include the propensity of trademark development in the host country.

The model also controls for the variables that are normally part of the gravity model analysis, including market size and distance. Aminian et al. (2005) proposed that market seeking investors, *ceteris paribus*, look for large markets. Previous research suggests the inclusion of either GDP or population (UNCTAD, 1993; Hufbauer et al., 1994; Buckley et al., 2007). Both these variables have an expected positive sign. As already mentioned the countries' openness to trade also influences the attraction of FDI. Nonnenberg and Cardoso de Mendonça (2004) concluded that the trade openness of an economy is a relevant indicator of the positive attitude and policy of a country towards FDI. Therefore, trade openness is assumed to have a positive sign (Al Nasser, 2007; Torrisi, et al., 2008).

The location choice of greenfield investment projects is the dependent variable in the model. Conditional logistic regressions are used to analyse the locational determinants. Conditional logistic regressions fit perfectly for what economists call fixed-effects logit for panel data. The advantage of using conditional logistic regressions is that it can link the theoretical objective function of a representative location-seeking agent with the likelihood function of the empirical model (Alcacer and Chung, 2007; Hong, 2009; McFadden, 1974; Duanmu, 2010).

The data are formatted to fit for conditional logistic regressions by modelling the entry into a host country against all other countries that did not receive the entry. Depending on how many host countries have received a positive number of entries from China and India each year, all other countries that did not host such establishments are modelled as possible alternatives. Consequently the basis for the analysis consists of a matrix of 1071 Chinese and 1578 Indian investment projects in over 200 countries.

This gives the following model:

$$\#Y_{jit} = \beta_{0it} + \beta_1 \, INCOME\ DIFFERENCE_{it} + \beta_2 \, INSTITUTIONAL\ DISTANCE_{it} + \beta_3 \, STRATEGIC\ ASSETS_{it} + \beta_4 \, RESOURCES_{it} + \beta_6 \, CONTROL\ VARIABLES_{it} + \beta 7 \, DISTANCE_{ji} + \mu_{it}$$

Where:

i = the host country

j = the home country (China or India)

t = the year (2003–2008)

μ = error term

Regressions were run for split Chinese and Indian samples in order to be able to compare results. Given that the institutional variables such as control of corruption, regulatory quality, and rule of law – except for political stability – are collinear, they were included separately.

Table 1. Description of the variables

Variables	Name of variable	Information	Expected sign	Source
FDI	Y	Number of greenfield investments		fDi, Financial Times
Income difference				
Difference in per capita income	GDPCAPDIST	Difference in log (GDP per capita)	-	World Development Indicators
Institutional distance				
Political stability	POLSTABDIST	Difference in (Political stability estimate)	-	World Development Indicators World
Rule of law	ROLAWDIST	Difference in (Rule of law estimate)	-	Development Indicators
Control of corruption	CONCORDIST	Difference in (Control of corruption estimate)	-	World Development Indicators
Natural resources				
Ores and metal exports	RESOURCES	Ores and metal exports (% of exports)	+	World Development Indicators
Oil exports	OIL	Oil exports (% of exports)	+	World Development Indicators
Strategic assets				
Technology	lnPAT	Log (Number of resident patents)	+	World Development Indicators
Trademarks	lnTM	Log (Number of trademarks)	+	World Development Indicators
Control variables				
Distance from China to host countries	DCHINA	Simple distance between most populated cities	-	CEPII
Distance from India to host countries	DINDIA	Log (Gross Domestic Product)	-	CEPII
Market size	lnGDP	Export+imports/GDP	+	World Development Indicators
Market openness	OPENNESS		+	World Development Indicators

Results

The empirical results confirm the first hypothesis that Chinese and Indian TNCs prefer markets similar to their own. The coefficient for the difference in income is consistently negative and significant, indicating that income difference discourages investment. As such, similar markets present more attractive locations. Furthermore, larger markets and market openness are also important positive determinants of the direction of investments, although more so for Indian TNCs than Chinese TNCs. This finding is largely in line with the findings in the extant literature.

However, the institutional distance variables show some unexpected results. Differences in corruption do not yield a significant coefficient for Chinese investors, indicating that they do not target corrupt economic environments, in particular, and are rather indifferent towards corruption. This is in clear contrast to the Indian TNCs which are more put off by corruption. Differences in political stability detract both Chinese and Indian investments, indicating that they both prefer countries with similar political environments. This result also applies for regulatory quality, as both Chinese and Indian outward FDI is more attracted by better regulatory environments. In other words, although the emerging country TNCs from China and India are not put off by political risk, they apparently do not risk exposing their investments too much and seek locations where the rule of law plays a significant and positive role in the investment climate.

As is generally known, natural resources are an important investment motive for the attraction of Chinese TNCs. The findings indicate that this is also the case for Indian companies. The oil and mineral export propensity of host countries is positive and significant in all regression models, both for China and India.

With regard to the fourth hypothesis, the results again show a twofold answer. On the one hand, patents form an important attraction pole for Chinese investors. It looks as if Chinese TNCs seek to take full advantage of being part of an innovative environment to develop new products. This is not so much the case for Indian investors, who apparently target less innovative markets. On the other hand, both countries attempt to avoid highly competitive environments in terms of trademarks. Both of these results remain robust after excluding one

Table 2. Conditional logistic regression for Chinese and Indian greenfield investments (2003-2008)

Variable type	Variable name	Model China 1	Model China 2	Model India 1	Model India 2
Income difference	GDPCAPDIST	-.0000259 *** 0.000	-.0000328 *** 0.000	-.0000322 *** 0.000	-.0000248 *** 0.000
	POLSTABDIST	-.3184433 *** 0.000	-.3925472 *** 0.000	-.1805672 *** 0.002	-.1252908 ** 0.039
Institutional distance	ROLAWDIST		.2014362 ** 0.047		.1887996 *** 0.008
	CONCORDIST	.0272316 0.775		.3247845 *** 0.000	
Natural resources	RESOURCE	.0564074 *** 0.000	.0562301 *** .000	.0182156 *** 0.000	.0196028 *** 0.000
	OIL	.0261868 *** 0.000	.027124 *** 0.000	.0079637 *** 0.000	.0077082 *** 0.000
Strategic assets	lnPAT	.1092223 ** 0.020	.1225192 *** 0.009	-.0192816* 0.064	-.0158935 0.124
	lnTM	-.3806937 *** 0.000	-.3657873 *** 0.000	-.0367792 *** 0.000	-.0410564 *** 0.000
Other	lnGDP	.8550691 *** 0.000	.8284626 *** 0.000	.8306368 *** 0.000	.8289313 *** 0.000
	TRADE OPENNESS	.0054529 *** 0.000	.0052577 *** 0.000	.00624 *** 0.000	.0067319 *** 0.000
	DISTANCE	-0.00000176 0.877	-0.00000144 0.895	-.000072 *** 0.000	-.0000655 0.000
Model	Number of investments	1071	1071	1578	1578
	Chi^2 ($Prob>Chi^2$)	836.11 0.0000	840.00 0.0000	2360.74 0.0000	2341.55 0.0000

Notes: **Variable coefficients and P> |z| significance levels are reported, which are also reflected in the number of *. Other institutional variables in replacement of the rule of law (ROLAWDIST) such as regulatory quality and government effectiveness yield similarly positive significant results.**

or the other variable. Therefore, technological assets appear to be more important for Chinese TNCs, ceteris paribus. Indian companies seem to possess better technological advantages than their Chinese counterparts, which make the search for technological expertise abroad less urgent and necessary than for Chinese companies.

Finally, geographic distance has a negative impact on Chinese and Indian investments, although the coefficients are not consistently significant for Chinese TNCs which have a higher proportion of more distant investment. Robustness checks for the simple geographic distance between the most important cities and the population weighted distance between the most important cities confirm these results.

5. Conclusion

Very few international business scholars can show a publication record that is comparable to John Dunning. Even though he covered most of the relevant themes of international business during his research efforts during more than a half century (Dunning and Lundan, 2008b), he attached enormous importance to location issues. Location was not only one of the very first issues he tackled at the beginning of his career, he also continuously stressed its importance for TNCs and governments and together with Porter put it back on the research agenda in the 1990s. Yet, already during the 1980s, John Dunning had analysed the ownership and location advantages with regard to outward direct investment (Dunning, 1981, 1986). Very early on, he noticed that while the physical distance was becoming less important as a result of technological and organizational developments, the "locational costs of traversing institutional distance" was increasing and presented new challenges for managers and academics. He stressed that, for instance the integrity of policies with regard to the environment, corruption, transparency, as well as the political and legal system were essential characteristics of institutional distance and added that "on these issues, we are at the very early stages of understanding how reducing institutional space can be best tackled, and indeed, to what extent it *should* be reduced" (Dunning, 2009). Now that companies from emerging economies are joining the TNCs from the advanced nations as major investors, these issues have become even more relevant.

Our analysis of Chinese and Indian greenfield investments has confirmed some of these locational determinants of investment behaviour of TNCs from emerging countries but has also revealed some new traits. This paper has simultaneously taken up income and institutional distance in order to assess the impact and importance of home-grown market and non-market advantages on TNCs' investment decisions. Furthermore, the importance of natural resources and intellectual property, including patents and trademarks, on the direction of investment has been considered. To this end, by using a conditional logit gravity model of Chinese and Indian TNC's greenfield investment decisions have been analysed across the globe.

First, the results consistently indicate that market or income distance has a negative impact on Chinese and Indian outward investment, demonstrating the importance of emerging country TNCs' market advantages. In other words, TNCs from China and India tend to invest foremost in countries with similar market patterns that reflect their domestic market environment, thus giving credence to the role of market advantages on both countries' internationalization process. This was also the outcome of the studies by Hay et al. (2011a) and Pradhan (2011), notwithstanding their different databases and methodological approaches.

Second, non-market institutional distance apparently has a positive effect on Chinese and Indian TNCs. These companies prefer better institutional environments thereby indicating their interest in protecting their investments, although political stability as such does not seem to concern them all that much as they invest more in politically similar countries. Corruption appears to be more of a concern for Indian TNCs. In sum, Chinese and Indian TNCs do not seem to invest more in institutionally similar countries, thus suggesting that Emerging country TNCs' internationalization might be guided more by market-based advantages than by non-market-based advantages. Pradhan (2011) also found that political stability did not seem to have an effect on the locational decisions of the Chinese and Indian TNCs, thereby contradicting the findings of Buckley et al. (2007). He consequently concluded that these results do not bear any empirical support to the general belief that emerging TNCs, especially those from China, are attracted into countries marked by political instability.

Third, natural resources form a significant attraction for Chinese and Indian firms. Although the results indicate that natural-resource-seeking motives are extremely important to Chinese TNCs, Indian international companies also clearly favour oil and mineral exporting countries. Analysis in Pradhan (2011) also shows that natural resources, especially fuel, are strong determinants for Chinese companies, but that this is not the case for Indian firms venturing abroad.

Fourth, technology-seeking investments are apparently more important to Chinese than to Indian TNCs as the firms from India seem to target less patent-intensive countries. This is largely in line with these companies' acquisition behaviour as Chinese firms seem to be more aggressively targeting technological assets while Indian firms seem to prefer competitors in less competitive markets, and is confirmed by the results in Hay et al. (2011a). Indian firms seem to be going out on the basis of their existing ownership advantages, while Chinese seem to disproportionately target developed country firms, in particular in high-tech industries (De Beule and Duanmu, 2012). Both Chinese and Indian TNCs tend to avoid highly competitive markets with a high number of trademarks. Surprisingly, patents as an indication of strategic assets of host countries do not show up as significant in Pradhan (2011). However, Hay et al. (2011a) confirm our findings that targeting technology plays an important role. They draw the conclusion that a higher technological level of a particular sector by one percent increases the chances of the sector in the country being chosen as a location by 20 per cent.

Fifth, the results – in line with the studies by Hay et al. (2011a) and Pradhan (2011) – indicate that both Chinese and Indian TNCs are attracted to large markets as measured by the income and the population. Host country trade openness is also shown to be of significant importance because the subsidiaries owned by these Chinese and Indian groups need to be able to export as well as import goods and services. Pradhan (2011) also underlines the importance of a liberal FDI policy regime, even though a liberal treatment of FDI via bilateral agreements such as BITs (bilateral investment treaties) and DTTs (double taxation treaties) are inversely related to the locational pattern of outward direct investment by Chinese TNCs. It is an interesting result from Pradhan's analysis that offshore financial centres have a powerful attraction on Chinese and Indian investors. However, also according to Pradhan (2011), Indian TNCs invest more in larger countries represented by a large population and higher per capita income, whereas Chinese TNCs went more into smaller countries.

Finally, *ceteris paribus*, distance has a negative impact on Chinese and Indian investors. This is confirmed by Hay et al. (2011a). Yet the negative effect is higher for Indian firms. Although these Chinese and Indian firms seem to seek out natural resources and strategic assets the world over, controlling for capabilities, resources, markets and institutions, it is found that investors still prefer to invest in countries within the existing regional network. However, Pradhan (2011) states that geographical proximity is no longer a locational consideration for Indian outward investors, while this is still the case for Chinese investments.

It is not altogether surprising that there are differences in the locational determinants between Chinese and Indian TNCs for their outward investments. After all, India followed an import substitution policy much longer than China, while China since the beginning of the 2000s has pursued a more aggressive and pro-active promotion policy of its outbound investments. China's outward FDI, contrary to India, is mainly carried out by state owned enterprises. China is (still) regarded as the "factory of the world", while the service sector has become the largest contributor to India's economic growth. These are only a few differences between these two large countries.

Although the article yields some interesting conclusions, the analysis could benefit from the inclusion of more home countries. Even if China and India are clearly two important emerging investors, it would be interesting to include other Asian and global emerging investors. Another interesting avenue of research would be to analyse the changes over time. By lengthening the period of analysis, it would be possible to discern any changes that have occurred. The difference between the 1990s and the 2000s could be interesting, as well as the changes that have occurred as a result of the current crisis. Already at this stage there are indications that the response to the crisis has been different for Chinese and Indian outward FDI, at least in a European context (Hay et al. 2011b; De Beule and Van Den Bulcke, 2010b).

During half a century, John Dunning has been analysing the role of the locational determinants of international business activities. The location factor is a core in his eclectic or OLI paradigm and is frequently referred to by other scholars. Also when the interest in the locational factors had waned in international business studies, he was a prominent figure in resuscitating its relevance in the 1990s. He realized early on that globalization did not necessarily diminish the importance of the locational determinants, especially since the cultural and institutional dimensions of distance needed to be taken into account. When describing his long time interest in locational factors, John Dunning wrote: "From being primarily concerned with cost minimization/or market seeking goals of an initial FDI in the 1950s and 1960s, economists and international business scholars have increasingly come to focus on the ways in which the global competitive advantage of firms can be enhanced by learning and clusters; and on the reduction of cross-border transaction costs in a complex MNE system". He stressed that "a co-evolutionary and interdisciplinary approach needs to be adopted to understanding the composition of location advantages and their interaction with ownership and internalization strategies of firms" (Dunning, 2009: 30). This suggestion is definitely relevant for the study of transnational firms from emerging economies.

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John Dunning's writings on development: gradualism, agency and meaning*

Peter J. Buckley**

Over his long and productive life, John Dunning wrote a great deal. One of the primary concerns of his work was development. His work with the United Nations Conference on Trade and Development (UNCTAD) over the years from 1972 and the establishment of the United Nations "Eminent Persons Group" (Sagafi-Nejad and Dunning, 2008; Buckley, 2010) to his death in 2009 focused particularly on the role of transnational corporations (TNCs) in the development process.

This review concentrates on John Dunning's last writings on the subject of TNCs and development – most notably on his chapter entitled "Towards a new paradigm for development: implications for the determinants of international business activity" in his final book (Dunning, 2010: chapter 7).

The implicit development context of John Dunning's work

John Dunning's view on development was essentially gradualist. He saw development as a process of evolution. There is no real sense of conflict or threat in this process. Emerging economies are accommodated within the global system as they emerge and the potentially disruptive effects of this are either absorbed internally (perhaps through evolving institutions) or are smoothed out by processes between nations – rebalancing of economies, exchange rate realignments, multilateral agreement). Development therefore is a self-adjusting system in which growth, emergence (and decline) are assimilated in the global economic system fairly smoothly.[1]

Dunning also believed that thought, too, is an evolutionary system. Borrowing key ideas and synthesizing them into a greater whole was a key

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** Peter J. Buckley is Professor of International Business and Director of the Centre for International Business, University of Leeds. He is also Cheung Kong Scholar Chair Professor in the University of International Business and Economics, Beijing.

[1] For a summary of John Dunning's work on TNCs and development, see Dunning and Lundan (2008) particularly chapter 10.

method of Dunning's last foray into development processes (Dunning, 2010, Chapter 7). He was explicitly "standing on the shoulders of giants" and the giants he chooses are Amartya Sen, Joseph Stiglitz and Douglass North, all Nobel Prize winners.

Criticisms of the "Old Development Paradigm"

In order to advance the new approach to development based on the fundamentals derived from his earlier work together with the new elements from the "giants", Dunning set up something of a straw man – the "old development paradigm" (ODP). According to him, the "key propositions of the old development paradigm (ODP) were based on the premise that, as a group, the goals and characterises of the developing countries were fundamentally similar to those of developed countries except that the former were in an earlier stage of their development process" (Dunning, 2010: 149). This mindset was described by Dunning as "narrow", "linear", "utilitarian" (it concentrates on gross national product as the sole measure of welfare) and "static". It has a static economic approach that ignored the extent and quality of institutional infrastructure and social capital.

In the text, very few names are actually associated with ODP and those that are named are clearly using reductionist type modelling to convey some key essences of development – such as the need for the accumulation of critical amounts of capital to launch development from a stationary state. On the whole the "ODP" is an unfair characterization of development economists' views (even those around 1970) and serves merely as a backdrop for the New Development Paradigm (NDP), which Dunning was to announce later.

Two assertions – globalization driven development

Dunning proceeded to set up the New Development Paradigm (NDP) by making two assertions connected to "globalization and technological advances" (Dunning, 2010: 152). Political changes (the fall of the Berlin Wall, etc.) and dramatic advances in the ability to transfer "information, knowledge and learning" rapidly across great distances were "refashioning the content and form of the production and exchange activities of firms" (Dunning, 2010:153).

This led to two assertions. First, contemporary capitalism interconnects different behavioural mores and belief systems (because of increased cross border exchange of knowledge, ideas and information). Second, changes in incentive structures and the belief systems that underlay them rarely move in tandem with technical, economic or political change.

This looks, at first blush, to be a recipe for disorder and disruption. That may be a reasonable deduction (and it is to this author) but not to John Dunning, who sees order, and development, emerging from these major forces.

The New Development Paradigm

John Dunning utilized the work of Sen (1999), Stiglitz (1998, 2002) and North (1990, 1994, 2005) as elements in the NDP, fashioning a new synthesis from their contributions to development.

Dunning's take on Sen was that of a "value based approach to development". The key issue derived from Sen was the removal of "unfreedoms". The enhancement of "the more positive freedoms of choice, opportunity and personal capability" (Dunning, 2010:156 from Sen, 1999) makes substantive freedom a means, as well as an end to development. Dunning noted that Sen also paid attention to the upgrading of institutions.

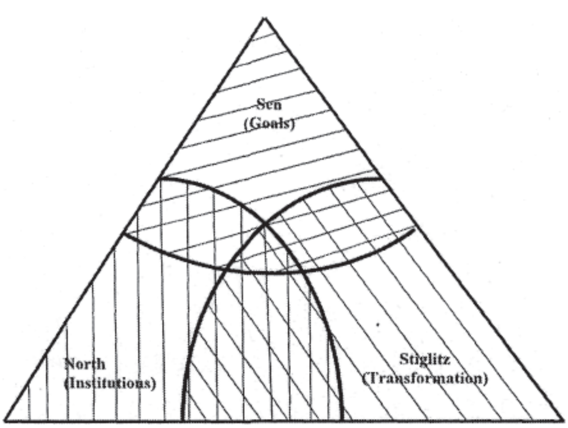
From Stiglitz (Stiglitz, 1998; Yusuf and Stiglitz, 2001), Dunning took the idea that development is primarily concerned with the "economic and structural transformation of resources, capabilities and preferences of societies; and that of the mindsets, values and entrepreneurship of its individual and organizational stakeholders" (Dunning, 2010: 157). Stiglitz emphasizes the dynamic interface between the institutional instruments of international organizations and the structural upgrading of nations. Stiglitz's approach is much more interventionist, even relying on outside interventions to secure a trajectory towards development. There is much more cognizance of partnerships, social capital, learning and an emphasis on the role of civil society.

Douglass North pays much more attention to institutions, particularly to incentive structures and enforcement systems in the development process. Institutions as "the rules of the game" govern the way that human beings structure their interactions. The balance between transaction costs and production costs will determine where activities take place and how this optimum location changes over time. Dunning alluded to some of the empirical evidence that the quality of a nation's institutions (and social capital) was one of the critical factors that distinguish faster growers from slower ones.

These views might have seemed to be discordant or subject to different domains of reference, but not for John Dunning. He simply placed each of these views as the corners of a triangle and produces figure 1 where goals (Sen), transformation (Stiglitz) and institutions (North) represented the domains of each "force". Thus, the triple-hatched centre of the triangle represents a development nirvana where positive institutions, reacting with supportive goals (linked to incentives) and transformational change occurs. Good, but less good, are areas where only two positive effects react together and the corners represent little that is positive towards development.

Dunning suggested that institutionally related variables were a necessary adjunct to the eclectic paradigm. Locational (L) factors can easily incorporate this as the quality of institutions in individual countries are a major determinant of their attractiveness and sustainability as an investment location. Internalization factors (I) in fact already incorporate an institutional element – firm versus market – but

Figure 1. The Sen/Stiglitz/North (overlapping) perspectives on the NDP



Source: John Dunning (2010:155).

Dunning (never really at ease with internalization theory) unnecessarily complicated this by introducing "institutionally related competitive advantages". Unfortunately, the eclectic theory expounded in figure 1 is extremely complicated with three types of ownership advantages, and location and internalization factors having a subset related to institutions. Dunning also introduced R, C, M – resources, capabilities and market opportunities into the NDP and the taxonomy sinks under its own weight.

Better perhaps to return to some earlier writing of Dunning's where investment was clearly related to (net) foreign investment: the investment development path.

The Investment Development Path

It is perhaps surprising that Dunning's (2010) earliest reference to his own work in chapter 7 is to 1993. No reference at all is made to the Investment Development Path (IDP) which he pioneered from the 1970s and 1980s (Dunning 1981a, 1981b).[2]

In the IDP (originally the investment development cycle), Dunning and collaborators attempted to plot the relationship between net inward/outward foreign direct investment (FDI) and development (proxied by income levels). Early stages of this relationship show a negative position as the country is host to incoming FDI. Then outward investment begins and at some point. As national income grows, outward FDI exceeds inward and the country becomes a net exporter of FDI. These basic relationships do not show causality but are suggestive of underlying relationships. Better, perhaps, to have separate plots of inward FDI versus income and outward FDI versus income, but it is at least possible and worthy of investigation that net flows have an important meaning. Further, the relationship between inward and outward flows is worthy of investigation – do inward flows through linkages, spillovers, income and demonstration effects stimulate outward FDI? Is this true in all circumstances and in all industries? What are the policy implications of these presumed relationships?

These issues seem to have been abandoned by Dunning. The IDP is certainly worthy of criticism for its lack of causality, but meaning can

[2] See also footnote 1 in Buckley and Castro (1998).

certainly be induced into the conceptual structure by a judicious input of extra-IDP theory. I am unclear as to why this strand of theorizing, to which Dunning had contributed so much, received no mention in this final work. After all, IDP has the semblance of dynamics, it clearly relates FDI to income levels and it is potentially suggestive of policy prescriptions. It is also far more transparent than the constantly augmented three factor eclectic paradigm.

Institutions or culture?

Although John Dunning mentioned it, the piece on development by Buckley and Casson (1991) was not analysed in Dunning's chapter. Perhaps the difference in approach is illuminating. An emphasis on institutions suggest that the agency of individuals or groups can *change* incentives or institutions. They can "design in" development. An emphasis on culture is, however, to suggest that the situation is more difficult to change, more rigid and constraining to development. Culture, moreover, may be more resistant to change from external agencies (à la Stiglitz). Whereas institutions can be redesigned, even from *de novo* in principle, culture is often particularly resistant to external pressure. The creation of a culture of entrepreneurship may be much more problematic than creating institutions that foster entrepreneurship. If the domestic culture is inimical to entrepreneurship, will institutions designed to foster it be effective?

FDI and development

One of the major agents of development has long been held to be FDI under the agency of the TNC. It is clear that the TNC has changed over time, becoming much more locationally flexible and also increasingly utilizing non-equity modes of operation and externalizing many "non-core" activities through outsourcing and subcontracting (Buckley, 2007, 2009; Buckley and Ghauri, 2004). This is analysed in detail by Lundan and Mirza (2010). These organizational and locational changes are bound to have important implications for development, opening up new opportunities (subcontracting by SMEs in developing countries, for example) and potentially closing down avenues of growth (competitor firms finding it difficult to compete with globally integrated networks centred around TNCs).

John Dunning met this challenge by a fairly continual updating and redefinition of the elements in the OLI paradigm. His final contribution (2010) was no different – section 6 of chapter 7 is entitled "The determinants of international business: revising and extending the OLI paradigm". Sadly, the paradigm became unwieldy. Better, perhaps, to go back to the founding concepts of the paradigm and apply these analytically to the new world order.

Dunning's concentration on the role of technology was, however, apposite – the role of "created assets" has become crucial to the growth and profitability of TNCs. Indeed, extracting a return from intangible assets may be a good description of the role of modern TNCs. This, of course, has important development implications. TNCs need to create and exploit intangible assets (including brands) whilst protecting these assets from dissipation, copying and imitation. This, together with the ability to manage a complex globally integrated network, utilizing a plethora of modalities of operation, defines the modern TNC.

In a scenario where whole swathes of global activity are dominated by "global factories" (Buckley, 2007, 2009; Buckley and Ghauri, 2004), it is important to give attention to the incentives, policies and institutions that can foster development. Is it best (or under what circumstances is it best) for developing country firms to cooperate with global factories (as subcontractors, for example)? Alternatively, can developing countries build globally integrated networks centred on their own TNCs?

John Dunning had a clear philosophy of development that gradual changes, adapted through flexible institutions enabled both developing and developed nations to accommodate potentially disruptive, radical change. The key transmission agent of change was the TNC which itself needed to adapt its procedures, outlook and management. In the book he edited, *Making Globalisation Good* (Dunning, 2003), he laid out the underlying ethos that he felt would lead TNCs to have beneficial (moral as well as economic) effects on development. It is now for subsequent research to explore the meaning of "institutions" and "culture" in the development context. These are the crucial issues in international business and development in the near future. John Dunning's work laid a great deal of the groundwork for the future development of theory, practice and policy in this crucial area.

Perhaps now the time is right to build on Dunning's challenge to "make globalization good". A direct link to the strategies of TNCs could be made, were the Millennium Development Goals (MDGs) to be built directly into the decision-making core of TNCs. This could best be achieved by rewarding the top executives of TNCs, not only by reference to quarterly returns, but also by the contribution that their activity makes to the MDGs in the countries where they have significant operations. It can, of course, be argued that this presents measurement difficulties. It does, but this can be gradually refined and improved if there is a will to work on it. It might also be argued that including MDGs in reward packages leads to "goal confusion". But top executives of TNCs are used to making trade-offs – between profitability and market share, for instance. The inclusion of a proposal to include MDGs in the decision set of TNCs in the declaration following the World Investment Forum organized by UNCTAD in Xiamen (September 2010) is a first step (reference) but to move forward on this policy would be a fitting tribute to the development research tradition pioneered by John Dunning.

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UNCTAD's Investment Policy Reviews: Key policy lessons

Chantal Dupasquier, Massimo Meloni and Stephen Young*

Recognizing the potential of foreign direct investment (FDI) for development, the development community has sought measures to support developing countries to attract FDI and to maximize its benefits. In this context, the United Nations Conference on Trade and Development (UNCTAD) has developed its Investment Policy Review (IPR) programme to provide developing countries with recommendations for improving their business environment in order to better derive development gains from FDI. As a body of work, the IPR series has discerned common obstacles to FDI attraction among many developing countries. These include a lack of clear rules; ineffective policy implementation or follow-through; and FDI policies which do not reflect country-specific conditions, such as the level of development, the availability of infrastructure, skills and resource endowments. Drawing on a recently published report by UNCTAD, *Investment Policy Reviews: Shaping Investment Policies around the World*, this paper summarizes the lessons learnt from the programme and highlights issues and challenges for policy and corporate strategy on cross-border investment.

Key words: foreign direct investment, development, investment policies, regulations

JEL classifications: F21, F23, K20, G30, M16

1. Introduction

The United Nations Conference on Trade and Development (UNCTAD) launched its Investment Policy Review (IPR) programme in 1999 in response to a growing demand from developing countries for policy advice on FDI. Each IPR provides the country under review an independent and objective evaluation of the country's policy, regulatory and institutional environment for FDI, as well as customized recommendations to the Government for attracting and benefiting from flows of foreign direct investment (FDI).

* Chantal Dupasquier and Massimo Meloni are UNCTAD staff. Stephen Young is Professor of International Business at the University of Glasgow, United Kingdom.

Since the programme's inception, IPRs have been undertaken for over 30 countries around the world, covering least developed countries (LDCs), post-conflict countries, middle-income countries, as well as transition economies. The principle underpinning the IPR is to create preconditions for growth and poverty alleviation by promoting FDI and stimulating its interactions with the local private sector. The focus of the IPR is therefore to propose a series of reforms to the investment framework in recipient countries. Each IPR is systematically followed by implementation programmes in the subject country, for which UNCTAD cooperates intensively with other development partners to support the delivery of proposed solutions.[1]

The objective of this paper is to summarize the principal lessons for foreign investment policy and the role of FDI in the development process, based on the programme's experience. The paper draws on the recently published stocktaking report, *Investment Policy Reviews: Shaping Investment Policies around the World*, which reviews and synthesizes the challenges facing developing economies and the strategies recommended in the IPR series for attracting and benefiting from FDI. These lessons are also reflected in UNCTAD's Investment Policy Framework for Sustainable Development (UNCTAD 2012).

2. Lessons from the Investment Policy Review Programme

Through assessment of the investment climate in a range of developing countries, the IPR has identified a number of important lessons for investment policymaking and the development process. The IPR series shows that inward FDI and transnational corporations (TNCs) can play a significant role in, for example, meeting huge infrastructure needs, but the interactions between foreign investors and the local private sector are also vitally important. Attracting and benefiting from FDI, furthermore, places significant responsibility on host country governments in devising and implementing appropriate policies and regulations in areas such as human resource development, taxation and in creating effective institutions to ensure compliance and good

[1] For more details on the programme, its impact and country coverage, see www.unctad.org/ipr

governance. Some major policy lessons that have emerged from the IPR series are highlighted in the remainder of this section.

2.1 FDI policy needs to fully take local economic and social conditions into account.

The level of economic development and the specific challenges facing countries naturally has a large bearing on required FDI policy responses.

For instance, for the poorest countries, the lack of basic infrastructure, skills and a robust policy framework presents major challenges in attracting FDI. Political instability – even violent conflicts – and health issues such as HIV/AIDS and malaria endemic may add to the problems.

Even for more advanced developing countries, inadequate infrastructure and skills availability often present challenges as they seek to move into higher value-added activities. However, these are of a different dimension, relating, for example, to the effects of infrastructure weaknesses (e.g. high telecommunications charges) on competitiveness, and to human resource issues such as rising labour costs, weaknesses in science, engineering and technology education, and perhaps a limited pool of skilled professionals.

Issues such as R&D financing and attracting technology-based investment are more germane in advanced developing economies. Problems of weak governance tend to come into sharper focus in these countries (although problems of poor implementation of laws and corruption exist in many economies).

Challenges are different again in transition economies. The starting point for FDI policies for these countries has been the opening up and reforming of their economies for investors. Reforming large state-owned enterprises, often with a view to privatizing them at a later date, encouraging start-ups and fostering a culture of entrepreneurship have typically been central concerns.

Thus, even for the same objective of attracting FDI and maximizing its benefits, there are no universal policy prescriptions. Difference circumstances require different policy responses. In formulating FDI policy, policymakers therefore need to take into account the economic and social conditions of the country and ensure the compatibility of FDI policy with overall development strategy.

2.2 Regional integration is gaining salience as a policy measure to attract FDI, especially in poorer countries

Countries with small populations low income levels are at a disadvantage in attracting market-seeking FDI. Geographic factors such as being landlocked or sparsely populated often add to the difficulties. These disadvantageous conditions apply to most small island developing states (SIDS) and the majority of countries in Africa.

In this context, regional integration is becoming an important component in the arsenal for attracting FDI. Regional integration can enhance the attractiveness of member countries by increasing the potential market size from the investor perspective. Furthermore, regional integration is even more effective if the grouping, for instance, adopts a common regulatory framework or develops regional transport and communications networks.

To take a specific example, some of the regional agreements in Africa are beginning to evolve into genuine free trade areas with large market potential. For instance, the East African Community has created a market of 130 million people with a combined GDP of over $70 billion.

Development partners are promoting regional integration as key part of their aid for trade programmes. The revised ACP-EU-Partnership Agreement, for example, is strongly promoting regional integration as a mechanism for fostering cooperation and peace and security, promoting growth, and tackling cross-border challenges.

TNCs are also adopting a regional approach in devising their strategies. IPRs, for countries in East and West Africa, have observed that of TNCs seeking to expand operations and develop integrated value chains, a significant number of them have followed a regional strategy. In North Africa, too, there are illustrative cases of foreign affiliates with regional export mandates and of regional product specialization, some as long ago as in 1999.

2.3 Infrastructure matters greatly, and remains a formidable challenge

The standard of physical infrastructure is of paramount importance for the provision of services to consumers and for facilitating business activities. The quality of infrastructure is hence a major determinant of FDI attraction. Raising finance, providing the legal and regulatory framework, and undertaking projects present formidable challenges. There are no panaceas or quick fixes, but the IPR programme has drawn a number of lessons:

(i) Efforts to increase private sector involvement through public-private partnerships (PPPs) are important, with TNCs often having a principal role;

(ii) In LDCs and SIDs, donor support and public investment remain vital to the provision of basic infrastructure services;

(iii) Countries must develop a strong legal and regulatory framework, preferably prior to the entry of investors, and secure the capacity to facilitate and regulate projects;

(iv) Opportunities for smaller-scale initiatives, involving new players and appropriate technologies should be sought, including "impact investments" which explicitly incorporate social, environmental and developmental objectives into their business operations.

Recent data indicate that the share of private sector investment in telecommunications is as high as 62 per cent in Africa. In contrast, the private share of investment in transport and energy in Africa is only 11 per cent; and as little as 6 per cent in water and sanitation (McKinsey & Co., 2011). It suggests a need for devising regulatory frameworks that permit sufficient returns for investors, but at the same time ensure access to basic services for vulnerable segments of society.

2.4 Building human resources requires long-term commitment and innovative policies

The availability and costs of semi-skilled and skilled labour are major determinants of FDI flows and their contribution to the host economy. Building human capital is a process requiring long-term commitment and large-scale investments in the educational system at all levels, including in vocational training.

The IPR series has identified human resources as a key development constraint in many developing countries. The solutions proposed focus on three issues: (i) reform and liberalization of labour laws; (ii) establishing work permits and residence systems specifically designed for the entry of foreign workers and skills upgrading; and (iii) investment in education, including at university level.

The issue of facilitating the entry of foreign workers is highly sensitive in many countries. Systems of allocation of work permits for foreigners are often rigid and restrictive, despite suffering from a shortage of skilled labour in a number of fields. The IPR series has developed detailed proposals for the employment of foreigners, encompassing skills audits, and work permits and skills transfer policies.

Public investment in university education is a common response to skills shortages in the higher income developing countries of Africa and Central America. The IPR series has, additionally, presented proposals for foreign investment in education, in particular the establishment of world-class business schools as joint ventures between leading global universities and local partners. Some IPRs have extended such proposals to develop a strategy for FDI in education, incorporating regulatory, policy and institutional measures. The proposed regulatory measures include removing barriers to FDI in education and strengthening quality controls on universities; while policy and institutional measures are concerned with, for example, promoting region-wide recognition of qualifications, and building bridges between universities and the private sector.

2.5. Reform of the investment framework is a key precondition for both FDI attraction and private sector development

A major contribution of the IPR series is practical advice for reforming and modernizing the investment framework in host countries. Required reforms range from a complete overhaul of the investment code and general policies to detailed business-related measures. These legal/regulatory reforms are of enormous value in providing a secure and stable environment for investors, as well as ensuring adequate protection of the public interest. The non-FDI specific aspects of the investment climate show how policy measures affecting all businesses (taxation, access to land etc.) have a strong impact on a country's FDI attractiveness. Generally, there have been moves towards greater uniformity in investment frameworks, under the influence, for example, of World Trade Organization (WTO) rules concerning non-discriminatory treatment.

Among a range of requirements identified in the IPR series are:

(i) Ensuring coherence between policy objectives, policy tools adopted and their implementation;

(ii) Avoiding an over-reliance on fiscal incentives and reforming uncompetitive tax regimes.

(iii) Enacting competition policy and creating or strengthening related institutions

(iv) Strengthening the legal framework for land rights and ownership to facilitate access to land and transfer of land titles.

(v) Exercising caution in signing up to international investment agreements and ensuring coherence between international commitments and domestic legislation so as to protect the country's policy space and avoid an undue rise in investor-State disputes.

(vi) Improving institutional effectiveness as a prerequisite for improving the investment climate

2.6 Reform of fiscal regimes should focus on core principles

With respect to the fiscal regime, the IPR series has focused on core principles of simplicity, predictability and the promotion of development goals, while ensuring adequate revenue streams to finance public expenditures.

The IPR series has often identified tax regimes and fiscal incentives which are:

(i) Overly complex and hence lacking in transparency, thus imposing very high administrative costs both upon investors and tax authorities;

(ii) Unstable and unpredictable, leading to investor confusion and loss of confidence;

(iii) Attractive for investors, but may encourage tax engineering, arbitrage and evasion, discourage start-ups and fail to produce sufficient revenue to provide essential public services and address the social and economic needs of the majority of the population; and

(iv) Not sufficiently targeted to promoting specific development goals, including technological upgrading, job creation and cluster development.

In a number of countries, general corporate taxation has been high but then significantly reduced by incentives, where almost everyone benefited. In such cases, the first step of the reform is to put in place a competitive general regime and in so doing simplify the tax system and reduce the transaction costs to investors. A competitive corporate tax regime is provided for all businesses, with the flexibility to support specific measures targeted at, for example, innovation and value chain development.

This consideration of the tax regime leads to a further key lesson which concerns the role of export processing zones (EPZs) and free zones (FZs or multi-facility zones) in development. While many developing countries have established such zones in the past, they have been widely criticized for expensive fiscal and other incentives, including subsidized rent and services; bureaucratic policy frameworks; and, in some cases, for inadequate coordination between private developers and governments in zone provision.

Lessons from the experience of the IPR programme are:

(i) Zones need to be integrated with host economies as direct benefits are extremely limited when zones operate as enclaves;

(ii) Associated with the above, the distinction between zones and the rest of the economy for tax purposes should be removed;

(iii) Zones should not be viewed as substitutes for a country's wider trade and investment activities;

(iv) The regulatory framework should provide streamlined procedures for business registration and operation;

(v) Private rather than public development of zones increases the likelihood of success; and the operation of zones should be undertaken by the private sector on a commercial basis;

Based on those lessons, general recommendations of the IPR programme include: (i) to change the profile of zones from EPZs to FZs with unlimited market access; (ii) to coordinate fiscal incentives inside and outside the zones; (iii) to adopt measures to encourage supplier development and linkages in target sectors in FZs; and (iv) to move to a greater role for the private sector in the development of zones.

The approach of the IPR programme is consistent with the WTO Agreement on Subsidies and Countervailing Measures, which prohibits incentives directly linked to export performance. This prohibition affects all the IPR countries in Central America; the final transition period for reforming FZ and maquila laws which are incompatible with WTO rules into general regimes ends in 2015.

2.7 The local private sector is critical to improving the benefits of FDI

An important aspect of investment framework reform is private sector development. The aim is to especially encourage local entrepreneurship and the development of small- and medium-sized enterprises (SME), with a view to enhancing absorptive capacity and facilitating linkages with and spillovers from FDI. Such programmes should promote five areas which enhance benefits gained through linkages, namely: (i) suppliers/buyers identification; (ii) transfers of technology; (iii) training, technical and managerial; (iv) information sharing in respect of technical requirements and future orders; and (v) financial support.

Linkages programmes have not always been successful, especially those established as part of government requirements through local content programmes in the 1970s and 1980s. Contemporary linkages programmes seek open, collaborative arrangements between willing partners, with long-term commitment from government and both foreign investors and local enterprises. There are still challenges from suppliers' ability to meet cost and quality standards, through them being able to supply in sufficient volumes to avoid production gaps among customer TNCs, to maintain stable relationships in areas such as pricing policies. However, stimulating a symbiotic relationship between TNCs and SMEs is crucial in the generation of dynamic economic benefits from FDI.

In several countries, there remains a philosophy of retaining a strong presence by State-owned enterprises (SOEs). The IPR recommendation, in these cases, was to move from a "steer and control" approach to a "regulate, enforce and monitor" policy stance. Thus steps were proposed to separate the ownership and regulatory functions of the State to ensure a level playing field between private companies and SOEs in commercial activities.

Elsewhere the challenge is to deal with poorly performing SOEs as part of a general governance issue. In such cases, SOEs need to be modernized to facilitate their effective participation in the provision of key infrastructure and social services. This is crucial as UNCTAD data show that, for example, the public sector still accounts for half of infrastructure investment in most developing countries.

Competition and regulatory issues also need to be considered. Telecommunications has often successfully attracted investment from a sufficient number of operators to render the industry competitive. However, in other industries such as water and energy, it is harder to introduce the same degree of competition in the industry. In such cases, there is a clear need for an effective regulatory regime to ensure that public monopolies are not replaced by private foreign monopolies, without the incentives and competitive pressures to invest in and improve services.

Countries may wish to retain a level of control over some infrastructure alongside foreign and other private investors. The need for a fair, transparent and effective regulation to ensure impartiality is all the more essential.

2.8 Effective institutions and implementation of laws matter greatly as part of improving public governance

Governance comprises two components: the design and effectiveness of laws and regulations; and the performance of regulatory institutions in the implementation of these laws.

Among the extensive range of challenges associated with weak institutional performance and poor implementation of laws are: (i) design of the tax system and low rates of tax collection; (ii) weaknesses in the rule of law and in the performance of the courts and the judicial system; (iii) red tape and bureaucracy; and (iv) land issues and property rights. Competition policies are sometimes non-existent or inadequate to protect consumers; and corruption is associated with weak institutions. One recommendation emerging from the IPRs to promote good governance is to establish a regulatory commission or equivalent.

Although these are long-standing issues in the context of FDI, both agriculture and land issues are high on the FDI and development agenda again. The challenges stem from concerns over food security, climate change, inadequate energy supplies, structural policy failures, and problems of land tenure (UNCTAD, 2009 and 2010). Secure property rights are vital in allowing private enterprise to flourish. The substantial contribution that the IPR programme have made in promoting secure land access, ownership and transfers is likely to be increasingly directed to property rights for agricultural land in the coming years.

2.9 An effective investment promotion agency is key for successful FDI attraction and facilitation

Many IPRs conducted by UNCTAD tackle the weaknesses of investment promotion agencies (IPA) — structure, governance, targeting and promotion strategies. In some countries, these IPRs have been instrumental for the radical overhaul of investment promotion agencies.

One of the recurring themes in this respect is IPAs' relative lack of attention to aftercare activities, in respect, for example, of linkages programmes and foreign affiliate development. Given the evidence of the importance of reinvested earnings FDI flows, the lack of interest may well result in missed opportunities. However, tracking of investors, both potential and established, is not widely undertaken. Other lessons include the necessity of high quality professionals and continued funding to ensure the sustainability of investment promotion activities, which often take time to bear fruit.

With an increasing number of governments promoting the internationalization of domestic enterprises and a continued focus on the promotion of export-oriented FDI by IPAs, it may be useful to integrate investment and trade promotion activities in one agency (UNCTAD, 2009). A growing number of countries operate in this way, and future IPRs, at least in more advanced developing economies, are likely to address this important issue.

2.10. FDI can play a significant role in the development process, but it is not a panacea

Assisted by strategic recommendations made by IPRs and their implementation, FDI has a potentially significant role to play in countries' development process. Apart from direct benefits in terms of employment, capital and know-how, the desirable function of FDI, however, is to harness the capabilities of the host country to attract and benefit from TNC activities, and to unleash the potential of domestic enterprises for the benefit of all its citizens. Hence a central policy objective is to integrate foreign investors within the business and societal fabric of the host economy.

While affiliates of TNCs have a potentially catalytic role to play, government policies also have a key input into this process by stimulating local enterprise development (primarily private but potentially also SOEs). These enterprise development policies range from encouraging entrepreneurship and start-ups; through formulating supplier development and export strategies, and cluster programmes; to helping build absorptive capacity to facilitate knowledge transfer from the foreign-owned sector.

Local enterprise development policies may also have a positive impact on the FDI attraction process by showing that the country is supportive of and open for business. A thriving SME sector is deemed to be necessary both to benefit from and to attract FDI.

The requirements for long-term sustainable development extend further to an all-inclusive, partnership approach which includes not only FDI and a flourishing private sector, but also official development assistance and good public governance. Donor-funded initiatives have been highly valuable in the implementation of IPRs; and have a major role to play alongside governments and foreign investors in PPPs in infrastructure.

These conditions required for FDI-led, self-sustaining growth are highly demanding. Attracting FDI itself is a difficult task, and achieving the benefits highlighted above can only be part of a long-term vision. FDI on its own is not a panacea for development, and what is required is an integrated approach to development involving the long-run commitment of all stakeholders. Host countries should be ambitious but must also be realistic in their aspirations for attracting and benefiting from FDI. The practical recommendations of the IPRs provide a platform for establishing the preconditions for private sector development (local and foreign), and building a robust local SME sector should be at least as high a policy priority as FDI attraction on the host country development agenda.

Conclusion and the way forward

The contribution of the IPRs lies in their practical, policy-oriented and customized approach, and in their strong emphasis on implementation. Their success relies heavily upon commitment from the recipient country, and the sustained support of a high-level local champion. The experience of implementation is significantly positive. Support through UNCTAD technical assistance, often in collaboration with other development partners, can be crucial; although a number of recipient countries have undertaken implementation on their own or alongside donors. Progress with infrastructure developments continues to be challenging, whereas the reform and modernization of investment frameworks has been a major success.

What do the IPRs add to our knowledge concerning FDI and development? The evidence from the review of IPRs suggests that overhaul of investment frameworks can provide an important stimulus to the process of FDI attraction and to overall market reform. This has been not been addressed to any great extent in academic and policy studies to date. By contrast the IPR evidence supports the growing literature on institutions and institutional infrastructure as a key FDI determinant.

The attraction of FDI *per se* is not an end but one element of the development process. Thus even greater emphasis should be given to the mechanisms through which FDI provides a catalyst for private sector development, job creation and poverty alleviation, including individual value-chains. Essentially, this means both helping to build a dynamic and growing domestic private sector in collaboration with foreign investors; and involving TNCs (and indeed all stakeholders) more closely in initiatives which are directly development-focused. Similarly greater consideration should be given to sectoral initiatives in manufacturing and agriculture where there is potential for strong linkages with local SMEs and, therefore, for poverty reduction. One particular contribution of the IPRs has been their focus upon firm-level issues, and, as with the *World Investment Report*, to apply international business, management and development theories and evidence to FDI policies. One example of this concerns multinational affiliate development programmes, which go beyond conventional aftercare for inward investors.

The world has changed considerably since 1999 and is likely to change again in perhaps unprecedented and unexpected ways over the course of this decade. For the future, a number of emerging issues will pose new policy challenges. The growing importance of new sources of FDI – South-South FDI, the role of SOEs and sovereign wealth funds, the rise of new business models and economic sectors will require innovative strategies and policy approaches. Furthermore, non-equity modes of international production, such as international subcontracting, management contracts or various forms of concessional arrangements are becoming of key importance. There are also new concepts generating interest in ideas such as 'corporate societal responsibility' and 'shared value' (Porter and Kramer, 2011). All these issues require a better understanding and call for further research to improve the policymaking process in the area of investment and foster development.

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WORLD INVESTMENT REPORT 2012: TOWARDS A NEW GENERATION OF INVESTMENT POLICIES

KEY MESSAGES

FDI trends and prospects

Global foreign direct investment (FDI) flows exceeded the pre-crisis average in 2011, reaching $1.5 trillion despite turmoil in the global economy. However, they still remained some 23 per cent below their 2007 peak.

UNCTAD predicts slower FDI growth in 2012, with flows levelling off at about $1.6 trillion. Leading indicators – the value of cross-border mergers and acquisitions (M&As) and greenfield investments – retreated in the first five months of 2012 but fundamentals, high earnings and cash holdings support moderate growth. Longer-term projections show a moderate but steady rise, with global FDI reaching $1.8 trillion in 2013 and $1.9 trillion in 2014, barring any macroeconomic shocks.

FDI inflows increased across all major economic groupings in 2011. Flows to developed countries increased by 21 per cent, to $748 billion. In developing countries FDI increased by 11 per cent, reaching a record $684 billion. FDI in the transition economies increased by 25 per cent to $92 billion. Developing and transition economies respectively accounted for 45 per cent and 6 per cent of global FDI. UNCTAD's projections show these countries maintaining their high levels of investment over the next three years.

Africa and the least developed countries (LDCs) saw a third year of declining FDI inflows. But prospects in Africa are brightening. The 2011 decline in flows to the continent was due largely to divestments from North Africa. In contrast, inflows to sub-Saharan Africa recovered to $37 billion, close to their historic peak.

Sovereign wealth funds (SWFs) show significant potential for investment in development. FDI by SWFs is still relatively small. Their cumulative FDI reached an estimated $125 billion in 2011, with about a quarter in developing countries. SWFs can work in partnership with host-country governments, development finance institutions or other private sector investors to invest in infrastructure, agriculture and industrial development, including the build-up of green growth industries.

The international production of transnational corporations (TNCs) advanced, but they are still holding back from investing their record cash holdings. In 2011, foreign affiliates of TNCs employed an estimated 69 million workers, who generated $28 trillion in sales and $7 trillion in value added, some 9 per cent up from 2010. TNCs are holding record levels of cash, which so far have not translated into sustained growth in investment. The current cash "overhang" may fuel a future surge in FDI.

UNCTAD's new FDI Contribution Index shows relatively higher contributions by foreign affiliates to host economies in developing countries, especially Africa, in terms of value added, employment and wage generation, tax revenues, export generation and capital formation. The rankings also show countries with less than expected FDI contributions, confirming that policy matters for maximizing positive and minimizing negative effects of FDI.

Investment policy trends

Many countries continued to liberalize and promote foreign investment in various industries to stimulate growth in 2011. At the same time, new regulatory and restrictive measures continued to be introduced, including for industrial policy reasons. They became manifest primarily in the adjustment of entry policies for foreign investors (in e.g. agriculture, pharmaceuticals); in extractive industries, including through nationalization and divestment requirements; and in a more critical approach towards outward FDI.

International investment policymaking is in flux. The annual number of new bilateral investment treaties (BITs) continues to decline, while regional investment policymaking is intensifying. Sustainable development is gaining prominence in international investment policymaking. Numerous ideas for reform of investor–State dispute settlement have emerged, but few have been put into action.

Suppliers need support for compliance with corporate social responsibility (CSR) codes. The CSR codes of TNCs often pose challenges for suppliers in developing countries (particularly small and medium-sized enterprises), which have to comply with and report under multiple, fragmented standards. Policymakers can alleviate these challenges and create new opportunities for suppliers by incorporating CSR into enterprise development and capacity-building programmes. TNCs can also harmonize standards and reporting requirements at the industry level.

UNCTAD's Investment Policy Framework for Sustainable Development

Mobilizing investment and ensuring that it contributes to sustainable development is a priority for all countries. A new generation of investment policies is emerging, as governments pursue a broader and more intricate development policy agenda, while building or maintaining a generally favourable investment climate.

"New generation" investment policies place inclusive growth and sustainable development at the heart of efforts to attract and benefit from investment. This leads to specific investment policy challenges at the national and international levels. At the national level, these include integrating investment policy into development strategy, incorporating sustainable development objectives in investment policy and ensuring investment policy relevance and effectiveness. At the international level, there is a need to strengthen the development dimension of international investment agreements (IIAs), balance the rights and obligations of States and investors, and manage the systemic complexity of the IIA regime.

To address these challenges, UNCTAD has formulated a comprehensive Investment Policy Framework for Sustainable Development (IPFSD), consisting of (i) Core Principles for investment policymaking, (ii) guidelines for national investment policies, and (iii) options for the design and use of IIAs.

UNCTAD's IPFSD can serve as a point of reference for policymakers in formulating national investment policies and in negotiating or reviewing IIAs. It provides a common language for discussion and cooperation on national and international investment policies. It has been designed as a "living document" and incorporates an online version that aims to establish an interactive, open-source platform, inviting the investment community to exchange views, suggestions and experiences related to the IPFSD for the inclusive and participative development of future investment policies.

OVERVIEW

FDI TRENDS AND PROSPECTS

Global FDI losing momentum in 2012

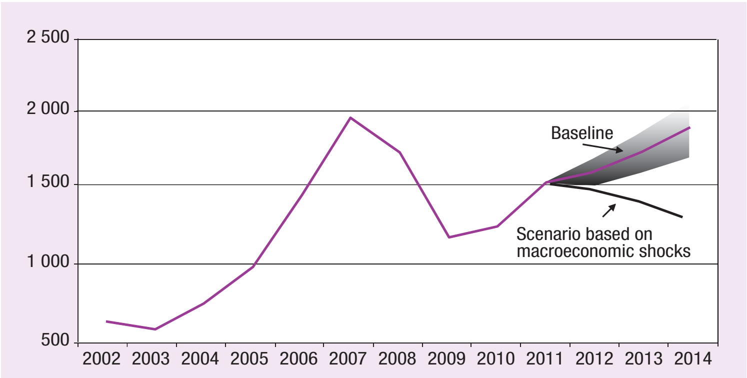
Global foreign direct investment (FDI) inflows rose 16 per cent in 2011, surpassing the 2005–2007 pre-crisis level for the first time, despite the continuing effects of the global financial and economic crisis of 2008–2009 and the ongoing sovereign debt crises. This increase occurred against a background of higher profits of transnational corporations (TNCs) and relatively high economic growth in developing countries during the year.

A resurgence in economic uncertainty and the possibility of lower growth rates in major emerging markets risks undercutting this favourable trend in 2012. UNCTAD predicts the growth rate of FDI will slow in 2012, with flows levelling off at about $1.6 trillion, the midpoint of a range (figure 1). Leading indicators are suggestive of this trend, with the value of both cross-border mergers and acquisitions (M&As) and greenfield investments retreating in the first five months of 2012. Weak levels of M&A announcements also suggest sluggish FDI flows in the later part of the year.

Medium-term prospects cautiously optimistic

UNCTAD projections for the medium term based on macroeconomic fundamentals continue to show FDI flows increasing at a moderate but

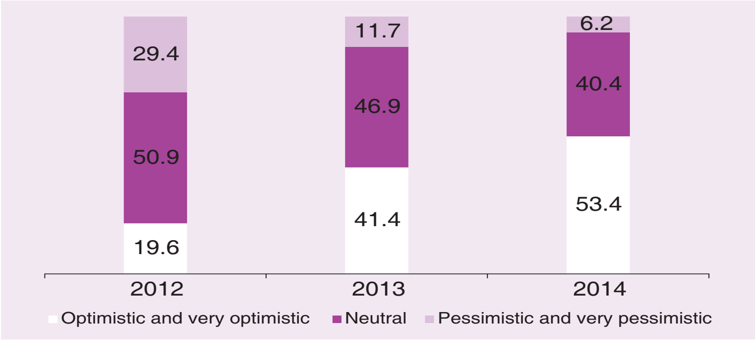
Figure 1. Global FDI flows, 2002–2011, and projection, 2012–2014
(Billions of dollars)



Source: UNCTAD, *World Investment Report 2012*.

steady pace, reaching \$1.8 trillion and \$1.9 trillion in 2013 and 2014, respectively, barring any macroeconomic shocks. Investor uncertainty about the course of economic events for this period is still high. Results from UNCTAD's *World Investment Prospects Survey* (*WIPS*), which polls TNC executives on their investment plans, reveal that while respondents who are pessimistic about the global investment climate for 2012 outnumber those who are optimistic by 10 percentage points, the largest single group of respondents – roughly half – are either neutral or undecided (figure 2). Responses for the medium term, after 2012, paint a gradually more optimistic picture. When asked about their planned future FDI expenditures, more than half of respondents foresee an increase between 2012 and 2014, compared with 2011 levels.

Figure 2. TNCs' perception of the global investment climate, 2012–2014
(Percentage of responses)



Source: UNCTAD, *World Investment Report 2012*.

FDI inflows up across all major economic groupings

FDI flows to developed countries grew robustly in 2011, reaching \$748 billion, up 21 per cent from 2010. Nevertheless, the level of their inflows was still a quarter below the level of the pre-crisis three-year average. Despite this increase, developing and transition economies together continued to account for more than half of global FDI (45 per cent and 6 per cent, respectively) for the year as their combined inflows reached a new record high, rising 12 per cent to \$777 billion (table 1). Reaching high level of global FDI flows during the economic and financial crisis it speaks to the economic dynamism and strong role of these countries in future FDI flows that they maintained this share as developed economies rebounded in 2011.

Rising FDI to developing countries was driven by a 10 per cent increase in Asia and a 16 per cent increase in Latin America and the Caribbean. FDI to the transition economies increased by 25 per cent to $92 billion. Flows to Africa, in contrast, continued their downward trend for a third consecutive year, but the decline was marginal. The poorest countries remained in FDI recession, with flows to the least developed countries (LDCs) retreating 11 per cent to $15 billion.

Indications suggest that developing and transition economies will continue to keep up with the pace of growth in global FDI in the medium term.

Table 1. FDI flows, by region, 2009–2011
(Billions of dollars and per cent

Region	FDI inflows			FDI outflows		
	2009	2010	2011	2009	2010	2011
World	**1 197.8**	**1 309.0**	**1 524.4**	**1 175.1**	**1 451.4**	**1 694.4**
Developed economies	606.2	618.6	747.9	857.8	989.6	1 237.5
Developing economies	519.2	616.7	684.4	268.5	400.1	383.8
Africa	52.6	43.1	42.7	3.2	7.0	3.5
East and South-East Asia	206.6	294.1	335.5	176.6	243.0	239.9
South Asia	42.4	31.7	38.9	16.4	13.6	15.2
West Asia	66.3	58.2	48.7	17.9	16.4	25.4
Latin America and the Caribbean	149.4	187.4	217.0	54.3	119.9	99.7
Transition economies	72.4	73.8	92.2	48.8	61.6	73.1
Structurally weak, vulnerable and small economies[a]	**45.2**	**42.2**	**46.7**	**5.0**	**11.5**	**9.2**
LDCs	18.3	16.9	15.0	1.1	3.1	3.3
LLDCs	28.0	28.2	34.8	4.0	9.3	6.5
SIDS	4.4	4.2	4.1	0.3	0.3	0.6
Memorandum: percentage share in world FDI flows						
Developed economies	50.6	47.3	49.1	73.0	68.2	73.0
Developing economies	43.3	47.1	44.9	22.8	27.6	22.6
Africa	4.4	3.3	2.8	0.3	0.5	0.2
East and South-East Asia	17.2	22.5	22.0	15.0	16.7	14.2
South Asia	3.5	2.4	2.6	1.4	0.9	0.9
West Asia	5.5	4.4	3.2	1.5	1.1	1.5
Latin America and the Caribbean	12.5	14.3	14.2	4.6	8.3	5.9
Transition economies	6.0	5.6	6.0	4.2	4.2	4.3
Structurally weak, vulnerable and small economies[a]	**3.8**	**3.2**	**3.1**	**0.4**	**0.8**	**0.5**
LDCs	1.5	1.3	1.0	0.1	0.2	0.2
LLDCs	2.3	2.2	2.3	0.3	0.6	0.4
SIDS	0.4	0.3	0.3	0.0	0.0	0.0

Source: UNCTAD, *World Investment Report 2012*.
[a] Without double counting.

TNC executives responding to this year's WIPS ranked 6 developing and transition economies among their top 10 prospective destinations for the period ending in 2014, with Indonesia rising two places to enter the top five destinations for the first time (figure 3).

The growth of FDI inflows in 2012 will be moderate in all three groups – developed, developing and transition economies (table 2). In developing regions, Africa is noteworthy as inflows are expected to recover. Growth in FDI is expected to be temperate in Asia (including East and South-East Asia, South Asia and West Asia) and Latin America. FDI flows to transition economies are expected to grow further in 2012 and exceed the 2007 peak in 2014.

Rising global FDI outflows driven by developed economies

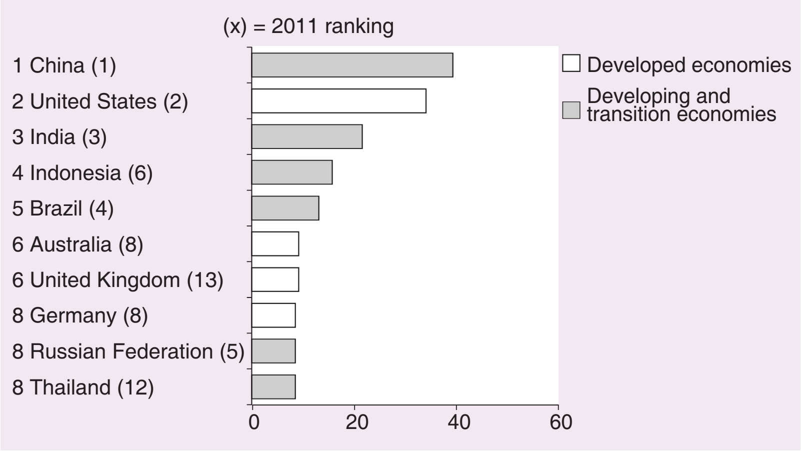
FDI from developed countries rose sharply in 2011, by 25 per cent, to reach $1.24 trillion. While all three major developed-economy investor blocs – the European Union (EU), North America and Japan – contributed to this increase, the driving factors differed for each. FDI from the United States was driven by a record level of reinvested earnings (82 per cent of total FDI outflows), in part driven by TNCs building on their foreign cash holdings. The rise of FDI outflows from the EU was driven by cross-border M&As. An appreciating yen improved the purchasing power of Japanese TNCs, resulting in a doubling of their FDI outflows, with net M&A purchases in North America and Europe rising 132 per cent.

Table 2. Summary of econometric results of medium-term baseline scenarios of FDI flows, by region
(Billions of dollars)

	Averages					Projections		
Host region	2005–2007	2009–2011	2009	2010	2011	2012	2013	2014
Global FDI flows	**1 473**	**1 344**	**1 198**	**1 309**	**1 524**	**1 495–1695**	**1 630–1 925**	**1 700–2 110**
Developed countries	**972**	**658**	**606**	**619**	**748**	**735–825**	**810–940**	**840–1 020**
European Union	646	365	357	318	421	410–450	430–510	440–550
North America	253	218	165	221	268	255–285	280–310	290–340
Developing countries	**443**	**607**	**519**	**617**	**684**	**670–760**	**720–855**	**755–930**
Africa	40	46	53	43	43	55–65	70–85	75–100
Latin America and the Caribbean	116	185	149	187	217	195–225	215–265	200–250
Asia	286	374	315	384	423	420–470	440–520	460–570
Transition economies	**59**	**79**	**72**	**74**	**92**	**90–110**	**100–130**	**110–150**

Source: UNCTAD, *World Investment Report 2012*.

Figure 3. TNCs' top 10 prospective host economies for 2012–2014
(Percentage of respondents selecting economy as a top destination)



Source: UNCTAD, *World Investment Report 2012*.

Outward FDI from developing economies declined by 4 per cent to $384 billion in 2011, although their share in global outflows remained high at 23 per cent. Flows from Latin America and the Caribbean fell 17 per cent, largely owing to the repatriation of capital to the region (counted as negative outflows) motivated in part by financial considerations (exchange rates, interest rate differentials). Flows from East and South-East Asia were largely stagnant (with an 9 per cent decline in those from East Asia), while outward FDI from West Asia increased significantly, to $25 billion.

M&As picking up but greenfield investment dominates

Cross-border M&As rose 53 per cent in 2011 to $526 billion, spurred by a rise in the number of megadeals (those with a value over $3 billion), to 62 in 2011, up from 44 in 2010. This reflects both the growing value of assets on stock markets and the increased financial capacity of buyers to carry out such operations. Greenfield investment projects, which had declined in value terms for two straight years, held steady in 2011 at $904 billion. Developing and transition economies continued to host more than two thirds of the total value of greenfield investments in 2011.

Although the growth in global FDI flows in 2011 was driven in large part by cross-border M&As, the total project value of greenfield investments remains significantly higher than that of cross-border M&As, as has been the case since the financial crisis.

Turnaround in primary and services-sector FDI

FDI flows rose in all three sectors of production (primary, manufacturing and services), according to FDI projects data (comprising cross-border M&As and greenfield investments) (table 3). Services-sector FDI rebounded in 2011 after falling sharply in 2009 and 2010, to reach some $570 billion. Primary sector investment also reversed the negative trend of the previous two years, at $200 billion. The share of both sectors rose slightly at the expense of manufacturing. Overall, the top five industries contributing to the rise in FDI projects were extractive industries (mining, quarrying and petroleum), chemicals, utilities (electricity, gas and water), transportation and communications, and other services (largely driven by oil and gas field services).

SWFs show potential for investment in development

Compared with assets of nearly $5 trillion under management, FDI by sovereign wealth funds (SWFs) is still relatively small. By 2011, their cumulative FDI reached an estimated $125 billion, with more than a quarter of that in developing countries. However, with their long-term and strategically oriented investment outlook, SWFs appear well placed to invest in productive sectors in developing countries, particularly the LDCs. They offer the scale to be able to invest in infrastructure development and the upgrading of agricultural productivity – key to economic development in many LDCs – as well as in industrial development, including the build-up of green growth industries. To increase their investment in these areas, SWFs can work in partnership with host-country governments, development finance institutions or other private sector investors that can bring technical and managerial competencies to projects.

Table 3. Sectoral distribution of FDI projects
(Billions of dollars and per cent)

Year	Value			Share		
	Primary	Manufacturing	Services	Primary	Manufacturing	Services
Average 2005–2007	130	670	820	8	41	50
2008	230	980	1 130	10	42	48
2009	170	510	630	13	39	49
2010	140	620	490	11	50	39
2011	200	660	570	14	46	40

Source: UNCTAD, *World Investment Report 2012*.

TNCs still hold back from investing record cash holdings

Foreign affiliates' economic activity rose in 2011 across all major indicators of international production (table 4). During the year, foreign affiliates employed an estimated 69 million workers, who generated $28 trillion in sales and $7 trillion in value added. Data from UNCTAD's annual survey of the largest 100 TNCs reflects the overall upward trend in international production, with the foreign sales and employment of these firms growing significantly faster than those in their home economy.

Despite the gradual advance of international production by TNCs, their record levels of cash have so far not translated into sustained growth in investment levels. UNCTAD estimates that these cash levels have reached more than $5 trillion, including earnings retained overseas. Data on the largest 100 TNCs show that during the global financial crisis they cut capital expenditures in productive assets and acquisitions (especially foreign acquisitions) in favour of holding cash. Cash levels for these 100 firms alone peaked in 2010 at $1.03 trillion, of which an estimated $166 billion was additional – above the levels suggested by average pre-crisis cash holdings. Although recent figures suggest that TNCs' capital expenditures in productive assets and acquisitions are picking up, rising 12 per cent in 2011, the additional cash they are holding – an estimated $105 billion in 2011 – is still not being fully deployed. Renewed instability in international financial markets will continue to encourage cash holding and other uses of cash such as paying dividends or reducing debt levels. Nevertheless, as conditions improve, the current cash "overhang" may fuel a future surge in FDI. Projecting the data for the top 100 TNCs over the estimated $5 trillion in total TNC cash holdings results in more than $500 billion in investable funds, or about one third of global FDI flows.

UNCTAD's FDI Attraction and Contribution Indices show developing countries moving up the ranks

The UNCTAD FDI Attraction Index, which measures the success of economies in attracting FDI (combining total FDI inflows and inflows relative to GDP), features 8 developing and transition economies in the top 10, compared with only 4 a decade ago. A 2011 newcomer in the top ranks is Mongolia. Just outside the top 10, a number of other countries saw significant improvements in their ranking, including Ghana (16), Mozambique (21) and Nigeria (23). Comparing the FDI Attraction Index with another UNCTAD index, the FDI Potential Index, shows that a number of developing and transition economies have managed to attract more FDI than expected, including Albania, Cambodia, Madagascar and Mongolia.

Others have received less FDI than could be expected based on economic determinants, including Argentina, the Philippines, Slovenia and South Africa.

The UNCTAD FDI Contribution Index – introduced in *WIR12* – ranks economies on the basis of the significance of FDI and foreign affiliates in their economy, in terms of value added, employment, wages, tax receipts, exports, research and development (R&D) expenditures, and capital formation (e.g. the share of employment in foreign affiliates in total formal employment in each country, and so forth). These variables are among the most important indicators of the economic impact of FDI. According to the index, in 2011 the host economy with the largest contribution by FDI was Hungary followed by Belgium and the Czech Republic. The UNCTAD FDI Contribution Index shows relatively higher contributions of foreign affiliates to local economies in developing countries, especially Africa, in value added, employment, export generation and R&D expenditures.

Comparing the FDI Contribution Index with the weight of FDI stock in a country's GDP (figure 4) shows that a number of developing and transition economies get a higher economic development impact "per unit of FDI" than others, including Argentina, the Plurinational State of Bolivia and Colombia and, to a lesser degree, Brazil, China and Romania. In other cases, FDI

Table 4. Selected indicators of FDI and international production, 1990–2011

Value at current prices (Billions of dollars)

Item	1990	2005–2007 pre-crisis average	2009	2010	2011
FDI inflows	207	1 473	1 198	1 309	1 524
FDI outflows	241	1 501	1 175	1 451	1 694
FDI inward stock	2 081	14 588	18 041	19 907	20 438
FDI outward stock	2 093	15 812	19 326	20 865	21 168
Income on inward FDI	75	1 020	960	1 178	1 359
Rate of return on inward FDI	*4.2*	*7.3*	*5.6*	*6.3*	*7.1*
Income on outward FDI	122	1 100	1 049	1 278	1 470
Rate of return on outward FDI	*6.1*	*7.2*	*5.6*	*6.4*	*7.3*
Cross-border M&As	99	703	250	344	526
Sales of foreign affiliates	5 102	20 656	23 866	25 622	27 877
Value-added (product) of foreign affiliates	1 018	4 949	6 392	6 560	7 183
Total assets of foreign affiliates	4 599	43 623	74 910	75 609	82 131
Exports of foreign affiliates	1 498	5 003	5 060	6 267	7 358
Employment by foreign affiliates (thousands)	21 458	51 593	59 877	63 903	69 065
Memorandum:					
GDP	22 206	50 411	57 920	63 075	69 660
Gross fixed capital formation	5 109	11 208	12 735	13 940	15 770
Royalties and licence fee receipts	29	156	200	218	242
Exports of goods and services	4 382	15 008	15 196	18 821	22 095

Source: UNCTAD.

appears to contribute less than could be expected by the volume of stock present in the country, as in Bulgaria, Chile and Jamaica. The latter group also includes a number of economies that attract significant investment largely because of their fiscal regime, but without the equivalent impact on the domestic economy.

Figure 4. FDI Contribution Index vs FDI presence, 2011
(Quartile rankings)

Above expectations | In line with expectations | Below expectations

FDI Contribution Index \ FDI inward stock/GDP	4th quartile (Low)	3rd quartile	2nd quartile	1st quartile (High)
High 1st quartile		Bolivia (Plurinational State of), Colombia, Finland, South Africa	Cambodia, Malaysia, Poland, Romania, Thailand, United Kingdom	Belgium, Czech Republic, Estonia, Hong Kong (China), Hungary, Ireland, Panama, Singapore, Sweden, Switzerland
2nd quartile	Argentina, Germany, Italy	Brazil, Dominican Republic, France, Slovenia	Bosnia and Herzegovina, Costa Rica, Croatia, Denmark, Honduras, Kazakhstan, Morocco, Norway, Portugal	Cyprus, Netherlands, Trinidad and Tobago
3rd quartile	China, Ecuador, Guatemala, Indonesia, Sri Lanka	Australia, Austria, Canada, Egypt, Lithuania, Peru, United Arab Emirates, Uruguay	Latvia, New Zealand, Spain, Ukraine	Bulgaria, Chile, Jamaica
4th quartile Low	Algeria, Greece, India, Japan, Kenya, Korea (Republic of), Paraguay, Philippines, Taiwan Province of China, Turkey, United States, Venezuela (Bolivarian Republic of)	Israel, Mexico, Russian Federation, Saudi Arabia		Bahamas, Barbados, Bermuda Luxembourg

Source: UNCTAD, *World Investment Report 2012*.

The FDI Contribution Index is the first attempt at a systematic comparative analysis of the contribution of FDI to economic development, a field in which data is extremely sparse. UNCTAD will continue to conduct research on the impact of investment and seek to improve on data and methodology for the index. UNCTAD is ready to engage with policymakers in the interpretation of the results, and to help countries improve national data collection.

RECENT TRENDS BY REGION

FDI to Africa continues to decline, but prospects are brightening

FDI inflows to Africa as a whole declined for the third successive year, to $42.7 billion. However, the decline in FDI inflows to the continent in 2011 was caused largely by the fall in North Africa; in particular, inflows to Egypt and Libya, which had been major recipients of FDI, came to a halt owing to their protracted political instability. In contrast, inflows to sub-Saharan Africa recovered from $29 billion in 2010 to $37 billion in 2011, a level comparable with the peak in 2008. A rebound of FDI to South Africa accentuated the recovery. The continuing rise in commodity prices and a relatively positive economic outlook for sub-Saharan Africa are among the factors contributing to the turnaround. In addition to traditional patterns of FDI to the extractive industries, the emergence of a middle class is fostering the growth of FDI in services such as banking, retail and telecommunications, as witnessed by an increase in the share of services FDI in 2011.

The overall fall in FDI to Africa was due principally to a reduction in flows from developed countries, leaving developing countries to increase their share in inward FDI to the continent (from 45 per cent in 2010 to 53 per cent in 2011 in greenfield investment projects).

South-East Asia is catching up with East Asia

In the developing regions of East Asia and South-East Asia, FDI inflows reached new records, with total inflows amounting to $336 billion, accounting for 22 per cent of global inflows. South-East Asia, with inflows of $117 billion, up 26 per cent, continued to experience faster FDI growth than East Asia, although the latter was still dominant at $219 billion, up 9 per cent. Four economies of the Association of Southeast Asian Nations (ASEAN) – Brunei Darussalam, Indonesia, Malaysia and Singapore – saw a considerable rise.

FDI flows to China also reached a record level of $124 billion, and flows to the services sector surpassed those to manufacturing for the first time. China continued to be in the top spot as investors' preferred destination for FDI, according to UNCTAD's *WIPS*, but the rankings of South-East Asian economies such as Indonesia and Thailand have risen markedly.

Overall, as China continues to experience rising wages and production costs, the relative competitiveness of ASEAN countries in manufacturing is increasing.

FDI outflows from East Asia dropped by 9 per cent to $180 billion, while those from South-East Asia rose 36 per cent to $60 billion. Outflows from China dropped by 5 per cent, while those from Hong Kong, China, declined by 15 per cent. By contrast, outflows from Singapore registered a 19 per cent increase and outflows from Indonesia and Thailand surged.

Rising extractive industry M&As boost FDI in South Asia

In South Asia, FDI inflows have turned around after a slide in 2009–2010, reaching $39 billion, mainly as a result of rising inflows in India, which accounted for more than four fifths of the region's FDI. Cross-border M&A sales in extractive industries surged to $9 billion, while M&A sales in manufacturing declined by about two thirds, and those in services remained much below the annual amounts witnessed during 2006–2009.

Countries in the region face different challenges, such as political risks and obstacles to FDI, that need to be tackled in order to build an attractive investment climate. Nevertheless, recent developments such as the improving relationship between India and Pakistan have highlighted new opportunities.

FDI outflows from India rose by 12 per cent to $15 billion. A drop in cross-border M&As across all three sectors was compensated by a rise in overseas greenfield projects, particularly in extractive industries, metal and metal products, and business services.

Regional and global crises still weigh on FDI in West Asia

FDI inflows to West Asia declined for the third consecutive year, to $49 billion in 2011. Inflows to the Gulf Cooperation Council (GCC) countries continued to suffer from the effects of the cancellation of large-scale investment projects, especially in construction, when project finance dried up in the wake of the global financial crisis, and were further affected by the unrest across the region during 2011. Among non-GCC countries the growth of FDI flows was uneven. In Turkey they were driven by a more than three-fold increase in cross-border M&A sales. Spreading political and social unrest has directly and indirectly affected FDI inflows to the other countries in the region.

FDI outflows recovered in 2011 after reaching a five-year low in 2010, indicating a return to overseas acquisitions by investors based in the region (after a period of divestments). It was driven largely by an increase in overseas greenfield projects in the manufacturing sector.

Latin America and the Caribbean: shift towards industrial policy

FDI inflows to Latin America and the Caribbean increased by 16 per cent to $217 billion, driven mainly by higher flows to South America (up 34 per cent). Inflows to Central America and the Caribbean, excluding offshore financial centres, increased by 4 per cent, while those to the offshore financial centres registered a 4 per cent decrease. High FDI growth in South America was mainly due to its expanding consumer markets, high growth rates and natural-resource endowments.

Outflows from the region have become volatile since the beginning of the global financial crisis. They decreased by 17 per cent in 2011, after a 121 per cent increase in 2010, which followed a 44 per cent decline in 2009. This volatility is due to the growing importance of flows that are not necessarily related to investment in productive activity abroad, as reflected by the high share of offshore financial centres in total FDI from the region, and the increasing repatriation of intracompany loans by Brazilian outward investors ($21 billion in 2011).

A shift towards a greater use of industrial policy is occurring in some countries in the region, with a series of measures designed to build productive capacities and boost the manufacturing sector. These measures include higher tariff barriers, more stringent criteria for licenses and increased preference for domestic production in public procurement. These policies may induce "barrier hopping" FDI into the region and appear to have had an effect on firms' investment plans. TNCs in the automobile, computer and agriculture-machinery industries have announced investment plans in the region. These investments are by traditional European and North American investors in the region, as well as TNCs from developing countries and Japan.

FDI prospects for transition economies helped by the Russian Federation's WTO accession

In economies in transition in South-East Europe, the Commonwealth of Independent States (CIS) and Georgia, FDI recovered some lost ground after two years of stagnant flows, reaching $92 billion, driven in large part by cross-border M&A deals. In South-East Europe, manufacturing FDI increased, buoyed by competitive production costs and open access to EU markets. In the CIS, resource-based economies benefited from continued natural-resource-seeking FDI. The Russian Federation continued to account for the lion's share of inward FDI to the region and saw FDI flows grow to the third highest level ever. Developed countries, mainly EU members, remained the most important source of FDI, with the highest share of projects (comprising cross-border M&As and greenfield investments), although projects by investors from developing and transition economies gained importance.

The services sector still plays only a small part in inward FDI in the region, but its importance may increase with the accession to the World Trade Organization (WTO) of the Russian Federation. Through WTO accession the country has committed to reduce restrictions on foreign investment in a number of services industries (including banking, insurance, business services, telecommunications and distribution). The accession may also boost foreign investors' confidence and improve the overall investment environment.

UNCTAD projects continued growth of FDI flows to transition economies, reflecting a more investor-friendly environment, WTO accession by the Russian Federation and new privatization programmes in extractive industries, utilities, banking and telecommunications.

Developed countries: signs of slowdown in 2012

Inflows to developed countries, which bottomed out in 2009, accelerated their recovery in 2011 to reach $748 billion, up 21 per cent from the previous year. The recovery since 2010 has nonetheless made up only one fifth of the ground lost during the financial crisis in 2008–2009. Inflows remained at 77 per cent of the pre-crisis three-year average (2005–2007). Inflows to Europe, which had declined until 2010, showed a turnaround while robust recovery of flows to the United States continued. Australia and New Zealand attracted significant volumes. Japan saw a net divestment for the second successive year.

Developed countries rich in natural resources, notably Australia, Canada and the United States, attracted FDI in oil and gas, particularly for unconventional fossil fuels, and in minerals such as coal, copper and iron ore. Financial institutions continued offloading overseas assets to repay the State aid they received during the financial crisis and to strengthen their capital base so as to meet the requirements of Basel III.

The recovery of FDI in developed regions will be tested severely in 2012 by the eurozone crisis and the apparent fragility of the recovery in most major economies. M&A data indicate that cross-border acquisitions of firms in developed countries in the first three months of 2012 were down 45 per cent compared with the same period in 2011. Announcement-based greenfield data show the same tendency (down 24 per cent). While UNCTAD's 2012 projections suggest inflows holding steady in North America and managing a modest increase in Europe, there are significant downside risks to these forecasts.

LDCs in FDI recession for the third consecutive year

In the LDCs, large divestments and repayments of intracompany loans by investors in a single country, Angola, reduced total group inflows to the lowest level in five years, to $15 billion. More significantly, greenfield investments in the group as a whole declined, and large-scale FDI projects remain concentrated in a few resource-rich LDCs.

Investments in mining, quarrying and petroleum remained the dominant form of FDI in LDCs, although investments in the services sector are increasing, especially in utilities, transport and storage, and telecommunication. About half of greenfield investments came from other developing economies, although neither the share nor the value of investments from these and transition economies recovered to the levels of 2008–2009. India remained the largest investor in LDCs from developing and transition economies, followed by China and South Africa.

In landlocked developing countries (LLDCs), FDI grew to a record high of $34.8 billion. Kazakhstan continued to be the driving force of FDI inflows. In Mongolia, inflows more than doubled because of large-scale projects in extractive industries. The vast majority of inward flows continued to be greenfield investments in mining, quarrying and petroleum. The share of investments from transition economies soared owing to a single large-scale investment from the Russian Federation to Uzbekistan. Together with developing economies, their share in greenfield projects reached 60 per cent in 2011.

In small island developing States (SIDS), FDI inflows fell for the third year in a row and dipped to their lowest level in six years at $4.1 billion. The distribution of flows to the group remained highly skewed towards taxfriendly jurisdictions, with three economies (the Bahamas, Trinidad and Tobago, and Barbados) receiving the bulk. In the absence of megadeals in mining, quarrying and petroleum, the total value of cross-border M&A sales in SIDS dropped significantly in 2011. In contrast, total greenfield investments reached a record high, with South Africa becoming the largest source. Three quarters of greenfield projects originated in developing and transition economies.

INVESTMENT POLICY TRENDS

National policies: investment promotion intensifies in crisis

Against a backdrop of continued economic uncertainty, turmoil in financial markets and slow growth, countries worldwide continued to liberalize and promote foreign investment as a means to support economic growth and development. At the same time, regulatory activities with regard to FDI continued.

Investment policy measures undertaken in 2011 were generally favourable to foreign investors. Compared with 2010, the percentage of more restrictive policy measures showed a significant decrease, from approximately 32 per cent to 22 per cent (table 5). It would, however, be premature to interpret this decrease as an indication of a reversal of the trend towards a more stringent policy environment for investment that has been observed in previous years – also because the 2011 restrictive measures add to the stock accumulated in previous years. The share of measures introducing new restrictions or regulations was roughly equal between the developing and transition economies and the developed countries.

The overall policy trend towards investment liberalization and promotion appears more and more to be targeted at specific industries, in particular some services industries (e.g. electricity, gas and water supply; transport and communication). Several countries pursued privatization policies. Other important measures related to the facilitation of admission procedures for foreign investment.

As in previous years, extractive industries proved the main exception inasmuch as most policy measures related to this industry were less favourable. Agribusiness and financial services were the other two industries with a relatively high share of less favourable measures.

More State regulation became manifest primarily in two policy areas: (i) an adjustment of entry policies with regard to inward FDI by introducing new entry barriers or by reinforcing screening procedures (in e.g. agriculture, pharmaceuticals) and (ii) more regulatory policies in extractive industries, including nationalization, expropriation or divestment requirements as well as increases in corporate taxation rates, royalties and contract renegotiations. Both policy types were partly driven by industrial policy considerations.

In 2011–2012, several countries took a more critical approach towards outward FDI. In light of high domestic unemployment, concerns are rising that outward FDI may contribute to job exports and a weakening of the domestic industrial base. Other policy objectives include foreign exchange stability and an improved balance of payments. Policy measures undertaken included outward FDI restrictions and incentives to repatriate foreign investment.

IIAs: regionalism on the rise

By the end of 2011, the overall IIA universe consisted of 3,164 agreements, which include 2,833 bilateral investment treaties (BITs) and 331 "other IIAs", including, principally, free trade agreements (FTAs) with investment provisions, economic partnership agreements and regional agreements (*WIR12* no longer includes double taxation treaties among IIAs). With a total of 47 IIAs signed in 2011 (33 BITs and 14 other IIAs), compared with 69 in 2010, traditional investment treaty making continued to lose momentum (figure 5). This may have several causes, including (i) a gradual shift towards regional treaty making, and (ii) the fact that IIAs are becoming increasingly controversial and politically sensitive.

In quantitative terms, bilateral agreements still dominate; however, in terms of economic significance, regionalism becomes more important. The increasing economic weight and impact of regional treaty making is evidenced by investment negotiations under way for the Trans-Pacific Partnership (TPP) Agreement; the conclusion of the 2012 trilateral investment agreement between China, Japan and the Republic of Korea; the Mexico–Central America FTA, which includes an investment chapter; the fact that at the EU level the European Commission now negotiates investment agreements on behalf of all EU member States; and developments in ASEAN.

Table 5. National regulatory changes, 2000–2011
(Number of measures)

Item	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Number of countries that introduced changes	45	51	43	59	80	77	74	49	41	45	57	44
Number of regulatory changes	**81**	**97**	**94**	**126**	**166**	**145**	**132**	**80**	**69**	**89**	**112**	**67**
More favourable to investment	75	85	79	114	144	119	107	59	51	61	75	52
Less favourable to investment	5	2	12	12	20	25	25	19	16	24	36	15
Neutral/indeterminate	1	10	3	0	2	1	0	2	2	4	1	0

Source: UNCTAD, *World Investment Report 2012*.

In most cases, regional treaties are FTAs. By addressing comprehensively the trade and investment elements of international economic activities, such broader agreements often respond better to today's economic realities, in which international trade and investment are increasingly interconnected (see *WIR11*). While this shift can bring about the consolidation and harmonization of investment rules and represent a step towards multilateralism, where the new treaties do not entail the phase-out of the old ones, the result can also be the opposite. Instead of simplification and growing consistency, regionalization may lead to a multiplication of treaty layers, making the IIA network even more complex and prone to overlaps and inconsistencies.

Sustainable development: increasingly recognized

While some IIAs concluded in 2011 keep to the traditional treaty model that focuses on investment protection as the sole aim of the treaty, others include innovations. Some new IIAs include a number of features to ensure that the treaty does not interfere with, but instead contributes to countries' sustainable development strategies that focus on the environmental and social impact of investment.

A number of other recent developments also indicate increased attention to sustainable development considerations. They include the 2012 revision of the United States Model BIT; the 2012 Joint Statement by the European Union and the United States, issued under the auspices of the Transatlantic Economic Council; and the work by the Southern African Development Community (SADC) on its model BIT.

Finally, increased attention to sustainable development also manifested itself in other international policymaking related to investment, e.g. the adoption of and follow-up work on the 2011 UN Guiding Principles on

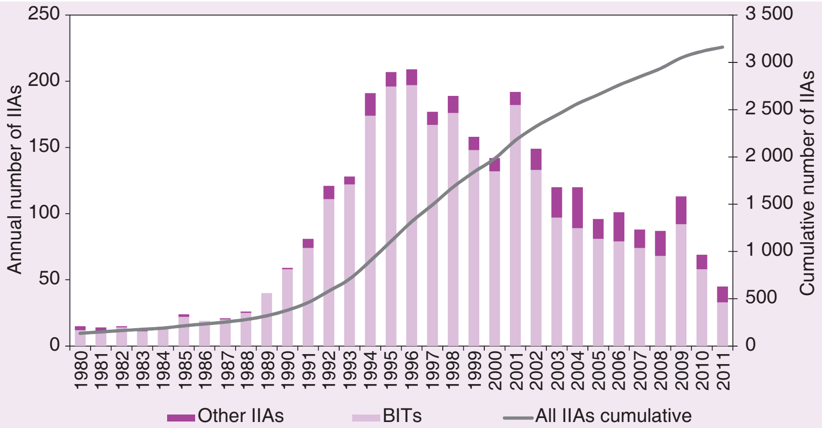
Business and Human Rights; the implementation of the UNCTAD/FAO/World Bank/IFAD Principles for Responsible Agricultural Investment; the 2011 Revision of the OECD Guidelines for Multinational Enterprises (1976); the 2012 Revision of the International Chamber of Commerce Guidelines for International Investment (1972); the Doha Mandate adopted at UNCTAD's XIII Ministerial Conference in 2012; and the Rio+20 Conference in 2012.

ISDS reform: unfinished agenda

In 2011, the number of known investor–State dispute settlement (ISDS) cases filed under IIAs grew by at least 46. This constitutes the highest number of known treaty-based disputes ever filed within one year. In some recent cases, investors challenged core public policies that had allegedly negatively affected their business prospects.

Some States have been expressing their concerns with today's ISDS system (e.g. Australia's trade-policy statement announcing that it would stop including ISDS clauses in its future IIAs; Venezuela's recent notification that it would withdraw from the ICSID Convention). These reflect, among others, deficiencies in the system (e.g. the expansive or contradictory interpretations of key IIA provisions by arbitration tribunals, inadequate enforcement and annulment procedures, concerns regarding the qualification of arbitrators, the lack of transparency and high costs

Figure 5. Trend of BITs and other IIAs, 1980–2011
(Number)



Source: UNCTAD, *World Investment Report 2012*.

of the proceeding, and the relationship between ISDS and State–State proceedings) and a broader public discourse about the usefulness and legitimacy of the ISDS mechanism.

Based on the perceived shortcomings of the ISDS system, a number of suggestions for reform are emerging. They aim at reigning in the growing number of ISDS cases, fostering the legitimacy and increasing the transparency of ISDS proceedings, dealing with inconsistent readings of key provisions in IIAs and poor treaty interpretation, improving the impartiality and quality of arbitrators, reducing the length and costs of proceedings, assisting developing countries in handling ISDS cases, and addressing overall concerns about the functioning of the system.

While some countries have already incorporated changes into their IIAs, many others continue with business as usual. A systematic assessment of individual reform options and their feasibility, potential effectiveness and implementation methods (e.g. at the level of IIAs, arbitral rules or institutions) remains to be done. A multilateral policy dialogue on ISDS could help to develop a consensus about the preferred course for reform and ways to put it into action.

Suppliers need support for CSR compliance

Since the early 2000s, there has been a significant proliferation of CSR codes in global supply chains, including both individual TNC codes and industry-level codes. It is now common across a broad range of industries for TNCs to set supplier codes of conduct detailing the social and environmental performance standards for their global supply chains. Furthermore, CSR codes and standards themselves are becoming more complex and their implementation more complicated.

CSR codes in global supply chains hold out the promise of promoting sustainable and inclusive development in host countries, transferring knowledge on addressing critical social and environmental issues, and opening new business opportunities for domestic suppliers meeting these standards. However, compliance with such codes also presents considerable challenges for many suppliers, especially small and medium-sized enterprises (SMEs) in developing countries. They include, inter alia, the use of international standards exceeding the current regulations and common market practices of host countries; the existence of diverging and sometimes conflicting requirements from different TNCs; the capacity constraints of suppliers to apply international standards in day-to-day operations and to deal with complex reporting requirements and multiple on-site inspections; consumer and civil society concerns; and competitiveness concerns for SMEs that bear the cost of fully complying with CSR standards relative to other SMEs that do not attempt to fully comply.

Meeting these challenges will require an upgrade of entrepreneurial and management skills. Governments, as well as TNCs, can assist domestic suppliers, in particular SMEs, through entrepreneurship-building and capacity-development programmes and by strengthening existing national institutions that promote compliance with labour and environmental laws. Policymakers can also support domestic suppliers by working with TNCs to harmonize standards at the industry level and to simplify compliance procedures.

UNCTAD'S INVESTMENT POLICY FRAMEWORK FOR SUSTAINABLE DEVELOPMENT

A new generation of investment policies emerges

Cross-border investment policy is made in a political and economic context that, at the global and regional levels, has been buffeted in recent years by a series of crises in finance, food security and the environment, and that faces persistent global imbalances and social challenges, especially with regard to poverty alleviation. These crises and challenges are having profound effects on the way policy is shaped at the global level. First, current crises have accentuated a longer-term shift in economic weight from developed countries to emerging markets. Second, the financial crisis in particular has boosted the role of governments in the economy, in both the developed and the developing world. Third, the nature of the challenges, which no country can address in isolation, makes better international coordination imperative. And fourth, the global political and economic context and the challenges that need to be addressed – with social and environmental concerns taking centre stage – are leading policymakers to reflect on an emerging new development paradigm that places inclusive and sustainable development goals on the same footing as economic growth. At a time of such persistent crises and pressing social and environmental challenges, mobilizing investment and ensuring that it contributes to sustainable development objectives is a priority for all countries.

Against this background, a new generation of foreign investment policies is emerging, with governments pursuing a broader and more intricate development policy agenda, while building or maintaining a generally favourable investment climate. This new generation of investment policies has been in the making for some time and is reflected in the dichotomy in policy directions over the last few years – with simultaneous moves to further liberalize investment regimes and promote foreign investment, on the one hand, and to regulate investment in pursuit of public policy objectives, on the other. It reflects the recognition that liberalization, if it is to generate sustainable development outcomes, has to be accompanied – if not preceded – by the establishment of proper regulatory and institutional frameworks.

"New generation" investment policies place inclusive growth and sustainable development at the heart of efforts to attract and benefit from investment. Although these concepts are not new in and by themselves, to date they have not been systematically integrated in mainstream investment policymaking. "New generation" investment policies aim to operationalize sustainable development in concrete measures and mechanisms at the national and international levels, and at the level of policymaking and implementation.

Broadly, "new generation" investment policies strive to:

- create synergies with wider economic development goals or industrial policies, and achieve seamless *integration in development strategies*;
- foster *responsible investor behaviour* and incorporate principles of CSR;
- ensure *policy effectiveness* in their design and implementation and in the institutional environment within which they operate.

New generation investment policies: new challenges

These three broad aspects of "new generation" foreign investment policies translate into specific investment policy challenges at the national and international levels (tables 6 and 7).

Addressing the challenges: UNCTAD's IPFSD

To address these challenges, UNCTAD has developed a comprehensive Investment Policy Framework for Sustainable Development (IPFSD), consisting of (i) a set of Core Principles for foreign investment policymaking, (ii) guidelines for investment policies at the national level and (iii) options for the design and use of IIAs (figure 6).

UNCTAD's IPFSD is meant to provide guidance on cross-border investment policies, with a particular focus on FDI, although many of the guidelines in the section on national investment policies could also have relevance for domestic investment. Policies covered include those with regard to the establishment, treatment and promotion of investment; in addition, a comprehensive framework needs to look beyond investment policies per se and include investment-related aspects of other policy areas. Investment policies covered comprise national and international policies, because coherence between the two is fundamental. The IPFSD focuses on direct investment in productive assets; portfolio investment is considered only where explicitly stated in the context of IIAs.

Although a number of existing international instruments provide guidance to investment policymakers, UNCTAD's IPFSD distinguishes itself in several ways. First, it is meant as a comprehensive instrument for dealing with all aspects of policymaking at the national and international levels. Second, it puts a particular emphasis on the relationship between foreign investment and sustainable development, advocating a balanced approach between the pursuit of purely economic growth objectives by means of investment liberalization and promotion, on the one hand, and the need to protect people and the environment, on the other hand. Third, it underscores the interests of developing countries in investment policymaking. Fourth, it is neither a legally binding text nor a voluntary undertaking between States, but expert guidance by an international organization, leaving policymakers free to "adapt and adopt" as appropriate, taking into account that one single policy framework cannot address the specific investment policy challenges of individual countries.

The IPFSD's Core Principles: "design criteria"

The Core Principles for investment policymaking aim to guide the development of national and international investment policies. To this end, they translate the policy challenges into a set of "design criteria" for investment policies (table 8). Overall, they aim to mainstream sustainable development in investment policymaking, while confirming the basic principles of sound development-oriented investment policies, in a balanced approach.

The Core Principles are not a set of rules per se. They are an integral part of the IPFSD, which attempts to convert them, collectively and individually, into concrete guidance for national investment policymakers and options for negotiators of IIAs. As such, they do not always follow the traditional policy areas of a national investment policy framework, nor the usual articles of IIAs. The overarching concept behind the principles is sustainable development; the principles should be read as a package, because interaction between them is fundamental to the IPFSD's balanced approach.

The design of the Core Principles has been inspired by various sources of international law and politics. They can be traced back to a range of existing bodies of international law, treaties and declarations, including the UN Charter, the UN Millennium Development Goals, the "Monterrey Consensus", the UN Johannesburg Plan of Implementation and the Istanbul Programme of Action for the LDCs. Importantly, the 2012 UNCTAD XIII Conference recognized the role of FDI in the development process and called on countries to design policies aimed at enhancing the impact of foreign investment on sustainable development and inclusive growth, while underlining the importance of stable, predictable and enabling investment climates.

From Core Principles to national policy guidelines

The IPFSD's national investment policy guidelines translate the Core Principles for investment policymaking into numerous concrete and detailed guidelines that aim to address the "new generation" challenges for policymakers at the domestic level (see table 6 for the challenges). Table 9 provides an overview of (selected) distinguishing features of the IPFSD's national investment policy guidelines, with a specific focus on the sustainable development dimension.

The sustainable development features of the national policy guidelines imply that governments have the policy space to consider and adopt relevant measures. Such policy space may be restricted by international commitments. It is therefore essential to consider the IPFSD's national investment policy guidelines and its guidance for the design of IIAs as an integrated whole. Coherence between national and international

Table 6. National investment policy challenges

Integrating investment policy in development strategy	• Channeling investment to areas key for the build-up of productive capacity and international competitiveness • Ensuring coherence with the host of policy areas geared towards overall development objectives
Incorporating sustainable development objectives in investment policy	• Maximizing positive and minimizing negative impacts of investment • Fostering responsible investor behaviour
Ensuring investment policy relevance and effectiveness	• Building stronger institutions to implement investment policy • Measuring the sustainable development impact of investment

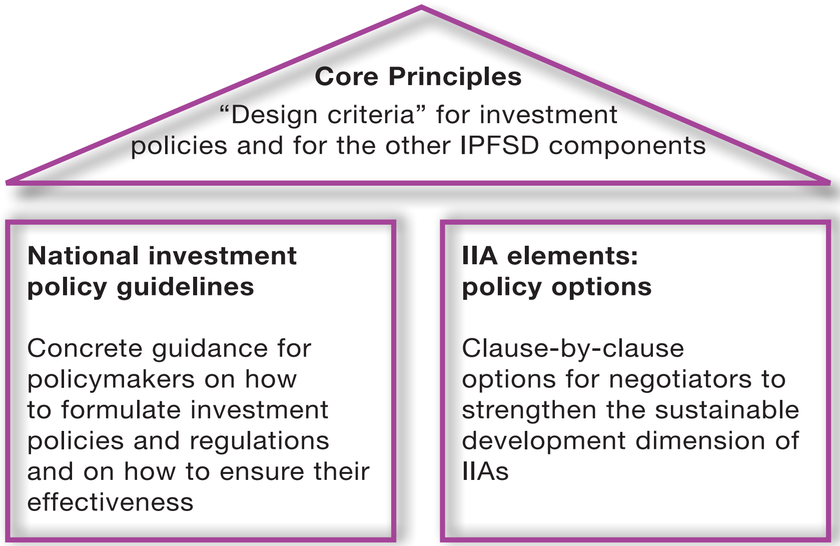
Source: UNCTAD, *World Investment Report 2012*.

Table 7. International investment policy challenges

Strengthening the development dimension of IIAs	• Safeguarding policy space for sustainable development needs • Making investment promotion provisions more concrete and consistent with sustainable development objectives
Balancing rights and obligations of states and investors	• Reflecting investor responsibilities in IIAs • Learning from and building on CSR principles
Managing the systemic complexity of the IIA regime	• Dealing with gaps, overlaps and inconsistencies in IIA coverage and content and resolving institutional and dispute settlement issues • Ensuring effective interaction and coherence with other public policies (e.g. climate change, labour) and systems (e.g. trading, financial)

Source: UNCTAD, *World Investment Report 2012*.

Figure 6. Structure and components of the IPFSD



Source: UNCTAD, *World Investment Report 2012*.

investment policies is crucial, with a view to, among others, avoiding policy discrepancies and investor–State disputes.

The national investment policy guidelines argue for policy action at the *strategic, normative*, and *administrative levels*.

At the *strategic* level, the IPFSD's national investment policy guidelines suggest that policymakers should ground investment policy in a broad road map for economic growth and sustainable development – such as those set out in formal economic or industrial development strategies in many countries. These strategies necessarily vary by country, depending on its stage of development, domestic endowments and individual preferences.

Defining the role of public, private, domestic and especially foreign direct investment in development strategy is important. Mobilizing investment for sustainable development remains a major challenge for developing countries, particularly for LDCs. Given the often huge development financing gaps in these countries, foreign investment can provide a necessary complement to domestic investment, and it can be particularly beneficial when it interacts in a synergetic way with domestic public and private investment.

At this level it is also important to develop policies to harness investment for productive capacity-building and to enhance international competitiveness, especially where investment is intended to play a central role in industrial upgrading and structural transformation in developing economies. Critical elements of productive capacity-building include human resources and skills development, technology and know-how, infrastructure development, and enterprise development. It is crucial to ensure coherence between investment policies and other policy areas geared towards overall development objectives.

At the *normative* level, IPFSD's national investment policy guidelines propose that through the setting of rules and regulations, on investment and in a range of other policy areas, policymakers should promote and regulate investment that is geared towards sustainable development goals.

Positive development impacts of FDI do not always materialize automatically. And the effect of FDI can also be negative. Reaping the development benefits from investment requires not only an enabling policy framework that provides clear, unequivocal and transparent rules for the entry and operation of foreign investors, it also requires adequate regulation to minimize any risks associated with investment. Such regulations need to cover policy areas beyond investment policies per se, such as trade, taxation, intellectual property, competition, labour market regulation, environmental policies and access to land.

Although laws and regulations are the basis of investor responsibility, voluntary CSR initiatives and standards have proliferated in recent years, and they are increasingly influencing corporate practices, behaviour and investment decisions. Governments can build on them to complement the regulatory framework and maximize the development benefits of investment.

At the *administrative* level, the guidelines make the point that through appropriate implementation and institutional mechanisms, policymakers should ensure the continued relevance and effectiveness of investment policies. Policies to address implementation issues should be an integral part of the investment strategy and should strive to achieve both integrity across government and regulatory institutions and a service orientation where warranted.

Measuring policy effectiveness is a critical aspect of investment policymaking. Investment policy should be based on a set of explicitly formulated policy objectives with clear priorities and a time frame for

Table 8. Core Principles for investment policymaking for sustainable development

Area	Core Principles
1 **Investment for sustainable development**	• The overarching objective of investment policymaking is to promote investment for inclusive growth and sustainable development.
2 **Policy coherence**	• Investment policies should be grounded in a country's overall development strategy. All policies that impact on investment should be coherent and synergetic at both the national and international levels.
3 **Public governance and institutions**	• Investment policies should be developed involving all stakeholders, and embedded in an institutional framework based on the rule of law that adheres to high standards of public governance and ensures predictable, efficient and transparent procedures for investors.
4 **Dynamic policymaking**	• Investment policies should be regularly reviewed for effectiveness and relevance and adapted to changing development dynamics.
5 **Balanced rights and obligations**	• Investment policies should be balanced in setting out rights and obligations of States and investors in the interest of development for all.
6 **Right to regulate**	• Each country has the sovereign right to establish entry and operational conditions for foreign investment, subject to international commitments, in the interest of the public good and to minimize potential negative effects.
7 **Openness to investment**	• In line with each country's development strategy, investment policy should establish open, stable and predictable entry conditions for investment.
8 **Investment protection and treatment**	• Investment policies should provide adequate protection to established investors. The treatment of established investors should be non-discriminatory.
9 **Investment promotion and facilitation**	• Policies for investment promotion and facilitation should be aligned with sustainable development goals and designed to minimize the risk of harmful competition for investment.
10 **Corporate governance and responsibility**	• Investment policies should promote and facilitate the adoption of and compliance with best international practices of corporate social responsibility and good corporate governance.
11 **International cooperation**	• The international community should cooperate to address shared investment-for-development policy challenges, particularly in least developed countries. Collective efforts should also be made to avoid investment protectionism.

Source: UNCTAD, *World Investment Report 2012*.

achieving them. These objectives should be the principal yard-stick for measuring policy effectiveness. Assessment of progress in policy implementation and verification of the application of rules and regulations at all administrative levels is at least as important as the measurement of policy effectiveness.

Objectives of investment policy should ideally include a number of quantifiable goals for both the *attraction* of investment and its *development contribution*. UNCTAD has developed – and field-tested – a number of indicators that can be used by policymakers for this purpose (table 10). In addition, UNCTAD's Investment Contribution Index can also serve as a starting point (see figure 4 above). To measure policy effectiveness for the *attraction* of investment, UNCTAD's Investment Potential and Attraction Matrix can be a useful tool.

The IPFSD's guidance on IIAs: design options

The guidance on international investment policies set out in UNCTAD's IPFSD translates the Core Principles into options for policymakers, with an analysis of sustainable development implications. While national investment policymakers address these challenges through rules, regulations, institutions and initiatives, at the international policy level this is done through a complex web of IIAs (including, principally, BITs, FTAs with investment provisions, economic partnership agreements and regional integration agreements). The complexity of that web, which leads to gaps, overlaps and inconsistencies in the system of IIAs, is itself one of the challenges to be addressed. The others include the need to strengthen the development dimension of IIAs, balancing the rights and obligations of States and investors, ensuring sufficient policy space for sustainable development policies and making investment promotion provisions more concrete and aligned with sustainable development objectives.

International investment policy challenges must be addressed at three levels:

- When formulating their *strategic approach* to IIAs, policymakers need to embed international investment policymaking into their countries' development strategies. This involves managing the interaction between IIAs and national policies (e.g. ensuring that IIAs support industrial policies) and that between IIAs and other international policies or agreements (e.g. ensuring that IIAs do not contradict international environmental agreements or human rights obligations). The overall objective is to ensure coherence between IIAs and sustainable development needs.

- In the *detailed design of provisions in investment agreements* between countries, policymakers need to incorporate sustainable development considerations, addressing concerns related to policy space (e.g. through reservations and exceptions), balanced rights and obligations of States and investors (e.g. through encouraging compliance with CSR standards), and effective investment promotion (e.g. through home-country measures).
- *International dialogue on key and emerging investment policy issues*, in turn, can help address some of the systemic challenges stemming from the multilayered and multifaceted nature of IIAs, including the gaps, overlaps and inconsistencies amongst these agreements, their multiple dispute resolution mechanisms, and their piecemeal and erratic expansion.

Addressing sustainable development challenges through the detailed design of provisions in investment agreements principally implies four areas of evolution in treaty-making practice:

- *Incorporating concrete commitments to promote and facilitate investment for sustainable development*. Options to improve the investment promotion aspect of treaties include concrete facilitation mechanisms (information sharing, investment promotion forums), outward investment promotion schemes (insurance and guarantees), and technical assistance and capacity-building initiatives targeted at sustainable investment, supported by appropriate institutional arrangements for long-term cooperation.
- *Balancing State commitments with investor obligations and promoting responsible investment*. For example, IIAs could include a requirement for investors to comply with investment-related national laws of the host State when making and operating an investment, and even at the post-operations stage, provided that such laws conform to the host country's international obligations. Such an investor obligation could be the basis for further stipulating in the IIA the consequences of an investor's failure to comply with domestic laws, such as the right of host States to make a counter

Table 9. Sustainable development features of the National Investment Policy Guidelines

Challenges	IPFSD National Investment Policy Guidelines – *selected features*
Integrating investment policy in development strategy	• Dedicated section (section 1) on *strategic investment priorities* and investment policy *coherence for productive capacity building*, including sub-sections on investment and: - Human resource development - Infrastructure (including section on public-private partnerships) - Technology dissemination - Enterprise development (including promoting linkages) • Attention to investment policy options for the *protection of sensitive industries* (sub-section 2.1) • Sections on other policy areas geared towards overall sustainable development objectives to ensure *coherence* with investment policy (section 3)
Incorporating sustainable development objectives in investment policy	• Specific guidelines for the design of investment-specific policies and regulations (section 2), including not only establishment and operations, treatment and protection of investments, and investment promotion and facilitation, but also *investor responsibilities* (as well as a dedicated sub-section on corporate responsibility, sub-section 3.7) • Guidance on the encouragement of *responsible investment* and on guaranteeing compliance with *international core standards* (sub-section 2.3) • Guidance on investment promotion and use of incentives in the *interest of inclusive and sustainable development* (sub-section 2.4) • Specific guidelines aimed at *minimizing potential negative effects of investment*, such as: - Addressing tax avoidance (sub-section 3.2) - Preventing anti-competitive behaviour (sub-sections 3.4 and 3.9) - Guaranteeing core labour standards (sub-section 3.5) - Assessing and improving environmental impact (sub-section 3.8) • A sub-section on access to land, incorporating the *Principles for Responsible Agricultural Investment* (PRAI) (sub-section 3.6)
Ensuring investment policy relevance and effectiveness	• Dedicated section on *investment policy effectiveness* (section 4), including guidance on public governance and institutional capacity-building • Guidance on the measurement of policy *effectiveness* (sub-section 4.3) and the effectiveness of specific measures (e.g. incentives), with reference to: - Specific quantitative investment impact indicators - Dedicated UNCTAD tools (FDI Attraction and Contribution Indices)

Source: UNCTAD, *World Investment Report 2012*. Detailed guidelines are also available in the online version of the IPFSD at www.unctad.org/DIAE/IPFSD.

claim in dispute settlement proceedings. In addition, IIAs could refer to commonly recognized international standards (e.g. the UN Guidelines on Business and Human Rights) and support the spread of CSR standards – which are becoming an ever more important feature of the investment policy landscape.

- *Ensuring an appropriate balance between protection commitments and regulatory space for development*. Countries can safeguard policy space by carefully crafting the structure of IIAs, and by clarifying the scope and meaning of particularly vague treaty provisions such as the fair and equitable treatment standard and expropriation, as well as by using specific flexibility mechanisms such as general or national security exceptions and reservations. The right balance between protecting foreign investment and maintaining policy space for domestic regulation should flow from each country's development strategy.
- *Shielding host countries from unjustified liabilities and high procedural costs*. The strength of IIAs in granting protection to foreign investors has become increasingly evident through the number of ISDS cases brought over the last decade, most of which have been directed at developing countries. Shielding countries from unjustified liabilities and excessive procedural costs through treaty design involves looking at options both in ISDS provisions and in the scope and application of substantive clauses.

These areas of evolution are also relevant for "pre-establishment IIAs", i.e. agreements that – in addition to protecting established investors – contain binding rules regarding the establishment of new investments. As a growing number of countries opt for the pre-establishment approach, it is crucial to ensure that any market opening through IIAs is in line with host countries' development strategies. Relevant provisions include selective liberalization, exceptions and reservations designed to protect a country from overcommitting, and flexibilities in the relevant treaty obligations.

Operationalizing sustainable development objectives in IIAs principally involves three mechanisms (table 11):

- Adjusting existing provisions to make them more sustainable-development-friendly through clauses that safeguard policy space and limit State liability.

Table 10. Possible indicators for the definition of investment impact objectives and the measurement of policy effectiveness

Area	Indicators	Details and examples
Economic value added	1. Total value added	• Gross output (GDP contribution) of the new/additional economic activity resulting from the investment (direct and induced)
	2. Value of capital formation	• Contribution to gross fixed capital formation
	3. Total and net export generation	• Total export generation; to an extent, net export generation (net of imports) is also captured by the (local) value added indicator
	4. Number of formal business entities	• Number of businesses in the value chain supported by the investment; this is a proxy for entrepreneurial development and expansion of the formal (tax-paying) economy
	5. Total fiscal revenues	• Total fiscal take from the economic activity resulting from the investment, through all forms of taxation
Job creation	6. Employment (number)	• Total number of jobs generated by the investment, both direct and induced (value chain view), dependent and self-employed
	7. Wages	• Total household income generated, direct and induced
	8. Typologies of employee skill levels	• Number of jobs generated, by ILO job type, as a proxy for job quality and technology levels (including technology dissemination)
Sustain-able develop-ment	9. Labour impact indicators	• Employment of women (and comparable pay) and of disadvantaged groups • Skills upgrading, training provided • Health and safety effects, occupational injuries
	10. Social impact indicators	• Number of families lifted out of poverty, wages above subsistence level • Expansion of goods and services offered, access to and affordability of basic goods and services
	11. Environmental impact indicators	• Greenhouse gas emissions, carbon off-set/credits, carbon credit revenues • Energy and water consumption/efficiency hazardous materials • Enterprise development in eco-sectors
	12. Development impact indicators	• Development of local resources • Technology dissemination

Source: UNCTAD, *World Investment Report 2012*.

- Adding new provisions or new, stronger paragraphs within provisions for sustainable development purposes to balance investor rights and responsibilities, promote responsible investment and strengthen home-country support.
- Introducing Special and Differential Treatment for the less developed party – with effect on both existing and new provisions – to calibrate the level of obligations to the country's level of development.

Table 11. Policy options to operationalize sustainable development objectives in IIAs

	Mechanisms	Examples
Adjusting existing/common provisions to make them more sustainable-development-friendly through clauses that: • safeguard policy space • limit State liability	Hortatory language	- *Preamble*: stating that attracting responsible foreign investment that fosters sustainable development is one of the key objectives of the treaty.
	Clarifications	- *Expropriation*: specifying that non-discriminatory good faith regulations pursuing public policy objectives do not constitute indirect expropriation. - *Fair and equitable treatment* (FET): including an exhaustive list of State obligations.
	Qualifications/ limitations	- *Scope and definition*: requiring covered investments to fulfil specific characteristics, e.g., positive development impact on the host country.
	Reservations/ carve-outs	- *Country-specific reservations* to national treatment (NT), most-favoured-nation (MFN) or pre-establishment obligations, carving out policy measures (e.g. subsidies), policy areas (e.g. policies on minorities, indigenous communities) or sectors (e.g. social services).
	Exclusions from coverage/exceptions	- *Scope and definition*: excluding portfolio, short-term or speculative investments from treaty coverage. - *General exception* for domestic regulatory measures that aim to pursue legitimate public policy objectives.
	Omissions	- Omit FET, umbrella clause.

/...

Table 11 (concluded)

	Mechanisms	Examples
Adding new provisions or new, stronger paragraphs within provisions for sustainable development purposes to: • balance investor rights and responsibilities • promote responsible investment • strengthen home-country support	Investor obligations and responsibilities	- Requirement that investors comply with host-State laws at both the entry and the operations stage of an investment. - Encouragement to investors to comply with universal principles or to observe applicable CSR standards.
	Institutional set-up for sustainable development impact	- Institutional set-up under which State parties cooperate to e.g. review the functioning of the IIA or issue interpretations of IIA clauses. - Call for cooperation between the parties to promote observance of applicable CSR standards.
	Home-country measures to promote responsible investment	- Encouragement to offer incentives for sustainable-development-friendly outward investment; investor compliance with applicable CSR standards may be an additional condition. - Technical assistance provisions to facilitate the implementation of the IIA and to maximize its sustainable development impact, including through capacity-building on investment promotion and facilitation.
Introducing Special and Differential Treatment for the less developed party – with effect on both existing and new provisions – to: • calibrate the level of obligations to the country's level of development	Lower levels of obligations	- Pre-establishment commitments that cover fewer economic activities.
	Development-focused exceptions from obligations/ commitments	- Reservations, carving out sensitive development-related areas, issues or measures.
	Best-endeavour commitments	- FET, NT commitments that are not legally binding.
	Asymmetric implementation timetables	- Phase-in of obligations, including pre-establishment, NT, MFN, performance requirements, transfer of funds and transparency.

Source: UNCTAD, *World Investment Report 2012*. Detailed option are also available in the online version of the IPFSD at www.unctad.org/DIAE/IPFSD.

The IPFSD and the way forward

UNCTAD's IPFSD comes at a time when the development community is looking for a new development paradigm, of which cross-border investment is an essential part; when most countries are reviewing and adjusting their regulatory frameworks for such investment; when regional groupings are intensifying their cooperation on investment; and when policymakers and experts are seeking ways and means to factor sustainable development and inclusive growth into national investment regulations and international negotiations.

The IPFSD may serve as a key point of reference for policymakers in formulating national investment policies and in negotiating or reviewing IIAs. It may also serve as a reference for policymakers in areas as diverse as trade, competition, industrial policy, environmental policy or any other field where investment plays an important role. The IPFSD can also serve as the basis for capacity-building on investment policy. And it may come to act as a point of convergence for international cooperation on investment issues.

To foster such cooperation, UNCTAD will continue to provide a platform for consultation and discussion with all investment stakeholders and the international development community, including policymakers, investors, business associations, labour unions, and relevant NGOs and interest groups.

For this purpose a new interactive, open-source platform has been created, inviting the investment and development community to exchange views, suggestions and experiences related to the IPFSD for the inclusive and participative development of future investment policies.

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