Foreign direct investment (FDI) is increasingly recognized, mainly since the 1980s, as a vital force in fostering long-term economic development. In addition to injecting capital, FDI has the much desired potential to create jobs, transfer technology (including management skills), enhance export capacity and raise productivity. The possible disadvantages of FDI or the possible conflict between transnational corporations (TNCs) and nation-states seem to have been forgotten or assumed to be controllable. Governments are competing among themselves to attract FDI by taking measures to improve the investment climate, such as reducing investment and trade restrictions and offering more incentives. To be sure, it is claimed that Governments in Latin America, for example, conceded too much to foreign private investors when they privatized public utilities. Complaints on abuses of monopoly power or excessive incentives incompatible with possible benefits are sometimes heard. Nevertheless, FDI is deemed as essential for the competitiveness of nations. The risks to the domestic economy or to the political, social and cultural fabric of the host countries are often ignored. Most researchers seem to agree that the benefit of FDI exceeds costs (Oxelheim and Ghauri, 2004, p. 10).

The World Investment Report 2004 includes, as one has learnt to expect, a wealth of interesting information and data. As in other such reports, the first part (chapters one and two) traces changes in the stocks and flows of FDI, including regional trends. Part Two discusses the shift of FDI towards services and the accelerated pace of the offshoring of corporate service functions. It examines the trends and analyzes the opportunities as well as the challenges that arise from these developments. Part Three examines national and international policy challenges. The Report includes 72 boxes with specific – sometimes anecdotal – information on many topics, ranging from
a list of the 50 largest TNCs from developing countries to a description of the rise and spread of retail TNCs to the GATS and subsidies. In addition, the WIR04 includes more than 150 tables and figures as well as a detailed and eye-opening statistical annex.

Part One presents figures on the trends and regional as well as sectoral distribution of FDI. It contains quite an optimistic outlook of FDI recovery after the major decline reported in 2003. Prospects are said to be particularly bright for services and for the relocation of a wide range of corporate functions. It reports that there are, at least, 61,000 TNCs with over 900,000 foreign affiliates. These affiliates account for one-tenth of the world GDP and one third of world’s exports, and their shares are increasing. The degree of transnationality of countries has also continued to rise. International production has been quite concentrated, but much less so than a decade ago. The 100 largest TNCs accounted for 12% of assets, 13% of employment and 14% of sales by all foreign affiliates compared with 21%, 21% and 27%, respectively, in 1990. In terms of the geographic spread, the most transnational of the TNCs is one only a few scholars would recognize as an obvious candidate, the Deutsche Post World Net with affiliates in 97 countries.

The WIR04 notes the increasing importance of outward FDI from developing countries. The overseas expansion of TNCs from developing countries is growing at a fast rate. From a negligible share in 1990, outward FDI from developing countries has increased to account for over one-tenth of the world’s total stock and 6% of the world total flows in 2003. Indeed, firms in these countries have learnt that to survive and flourish in a globalized world, they must be competitive internationally, which necessitates operating across national boundaries and holding a portfolio of assets in different locations.

As in the previous editions, the Report also presents several indices, aimed at capturing different phenomena related to FDI. Thus, the Inward Performance Index gauges the
The attractiveness of a country to FDI. The potential to attract FDI is measured by an Inward FDI Potential Index. The Transnationality Index is an attempt to measure the degree of transnationality of firms. WIR04 presents for the first time a new index – the Outward FDI Performance Index – measured as the ratio of a country’s share in world outward FDI flows to its share in world GDP. The leaders on this index are Belgium and Singapore, but also Luxembourg and Panama, because of transshipped FDI.

Statistics on the outflows of FDI places the United States in the first place, followed by Luxembourg, France and the United Kingdom, in this order. The high ranking of Luxembourg is a result of transshipped FDI. Both Panama and Luxembourg are at the top of the list of countries in terms of the Performance Index – mainly because these countries are used as tax havens. Hong Kong is another illustration. The territory is a top recipient of FDI inflows ($13.6 billion in 2003). It is also the seventh largest outward foreign direct investor and the largest among developing countries. More than a half of the outward FDI stock were to four tax havens, and round-tripping FDI from China through Hong Kong (China) and back was estimated at about 25% of outward FDI flows.

Statistics on FDI are based on information collected by UNCTAD, mostly from the individual countries, the International Monetary Fund and the Organisation for Economic Co-operation and Development. These sources are the best available, but are not free from limitations. The coverage of the data in different countries varies considerably. Thus, in the case of business services, some countries include the value of the real estate itself, not only the services of real estate agents. Hong Kong (China) and other economies include holding companies, which greatly inflate the value of FDI. Furthermore, to date, each country within the European Union is considered an independent entity. Therefore, an investment by an Irish airline in Belgium is considered FDI, even though the EU created one European Common Aviation Area, transforming intra-community air service from international to domestic.
UNCTAD defines a TNC as a parent enterprise and its foreign affiliates. A threshold of 10% of equity is considered sufficient. Under this definition, Canadian National Railway Company is one of the world’s 100 largest non-financial TNCs, although it operates only in two host countries. Raymond Vernon, in his studies, required operations in six countries for a firm to be classified as a TNC.

I could not find in WIR04 an explicit definition of the term “global industry”. The Report refers to the telecommunications industry as an emerging global industry because of the dramatic increase in inward FDI. Michael Porter defines a global industry as one in which “rivals compete against each other on a truly worldwide basis” (Porter, 1990, p. 54). When competition in each country is essentially independent, the industry is multi-domestic. Under this definition, neither telecoms nor water nor electricity supply is a global industry. In professional business services, there are a small number of giant networks, e.g. the Big Four in accounting competing with each other on a worldwide or, at least, regional basis. But there are also thousands of small firms operating domestically. Is the industry global? Some segments are – others are not. Again, definitions are non-trivial!

The definition of FDI is based on the balance of payments statistics. Thus, non-equity forms of FDI, such as sub-contracting, management contracts, turnkey arrangements, franchising, licensing and product sharing, are reflected only as receipts of royalty and management fees. In many services, non-equity forms are much more important than equity investment. To be sure, these limitations and others are all pointed out in the Report. Researchers using the data are well advised to read carefully the definitions in annex B of WIR04.

There are many regional differences, noted in chapter two. Outflows from the United States zoomed and resulted in a negative net balance in FDI flows of $122 billion – the highest deficit ever. WIR04 is silent on the prospects of a plunge in the dollar or revaluation of Asian currencies and the probable impact of such shifts on FDI flows.
Part Two of the Report analyses the growth of FDI in services and its economic impact – less so other implications, e.g. for international business theory. It notes a major shift in the composition of FDI. In the early 1970s, services accounted for about a quarter of the FDI stock. In 1990, the primary sector accounted for 9% of the world FDI stock, manufacturing for 42% and services for 49%. In 2002, the primary sector declined to 6%, manufacturing to 34% and services rose to about 60% of the world FDI stock. Between 1990 and 2002, the global stock of both inward and outward FDI in the primary sector more than doubled. During the same period, FDI in manufacturing rose three times while FDI in services more than quadrupled. Outward FDI in services, which were previously almost entirely from the United States, came also from the EU and Japan, and the share of developing countries climbed rapidly from 1% in 1990 to 10% in 2002.

The composition of FDI in services also saw a dramatic change. In 1990, 65% of the inward stock in services was in trade and finance. By 2002, the share of these two industries dropped to 47%. During the same period, a rapid expansion in FDI was noted in electricity, communication, postal services and water supply – all public utilities that were privatized and became open to foreign investors. Large increases were registered also in business services and in education. More recently, certain health services also became transnational. The value of the FDI stock in electric power generation and distribution increased 14-fold. In telecoms, storage and transport, the stock increased 16-fold and in business services, 9-fold. This major shift, the Report points out, came because countries had liberalized their service FDI regimes and privatized public utilities. Unlike manufacturing, and despite the increased cross-border tradability of information-intensive services, the integrated production of services is still in its embryonic stage. Thus, 84% of sales of services by foreign affiliates of United States TNCs in 2001 were local sales in host countries compared to 61% in goods.

Services comprised, in 2001, 72% of the GDP in developed countries, 52% in developing and 57% in Central
and East European (CEE) countries. Based on this indicator, WIR04 notes that there is a room for a vast increase in the share of service FDI. Today, international production networks in services are in their infancy, and services TNCs are significantly less transnationalized than their manufacturing counterparts (20% compared to 40%, according to United States data quoted in the Report). Yet, services are known to be less tradable, and certain services, e.g. security and other government services, media, health or education, may always be domestic for political, cultural or social reasons.

Moreover, there are two major reasons to believe that the statistics on services FDI underestimate the real size of this phenomenon. First, a large percentage of the services is embedded in goods. These services are not counted in official statistics as services, but as goods (usually manufacturing). Yet, much of the ownership specific advantages of manufacturing TNCs are based on design, computer technology and marketing efforts. The more complex the operation of a good, the higher the service component in it and the greater the probability that consumers buy a product based both on pre-production services such as market research or R&D and specific post-sales services (e.g. maintenance contract) that are deemed indispensable. These service functions are presented in the national statistics as a part of the production of goods. Only when the service functions are outsourced to a service organization they are counted as services.

Second, in several service industries, non-equity forms prevail rather than FDI. In the hotel industry, for example, it is a common practice for hotel operators to enter into management contracts without ownership of the real estate. The same is true in car rentals, restaurants, auditing, engineering, legal advice and other professional services. In all of these cases, the ownership advantage of firms is reflected in intangible assets such as reputation or organizational capabilities, information processing or managerial skills and knowledge (Aharoni, 2000). The physical assets are not owned by the TNCs. For very different reason, airlines are globalizers that are not allowed to
globalize. (For details see Aharoni, 2002). Inward FDI in European airlines has been constrained by ownership requirements in bilateral Air Service Agreements. They therefore are forced to use code sharing and strategic alliances to augment international competitiveness. In all of these cases, FDI stock and flow data do not capture these activities. The magnitude of these two statistical biases is not easy to establish. Clearly, therefore, the size of the services sector is grossly underestimated in the official statistics.

WIR04 notes (endnote 7, p. 148) that “it is difficult to say whether the full liberalization of FDI would result in much higher FDI”. It points out that in the hotel industry, most countries have lifted restrictions and seek not only the presence but also the capital investment of international hotel chains. My own research shows significant differences between the hotel and airline industries. As pointed out above, hotel chains achieve reputation by excellent management. These skills are different than those required to buy real estate. Airlines, too, do not have to own their planes – they can lease them. However, they must create – among other things – an efficient network. The Air Service Agreements prevent the use of a hub and spoke system, highly successful in the United States. The airlines industry is a global, mature and oligopolistic industry. One reason for its continued losses or low levels of returns on investment is the inability to reach economies of scale, of scope and mainly of network. If a guess may be offered, the liberalization of the airlines regime would result in a drastic consolidation through M&As (Aharoni, 2004). Certainly, one must study carefully the different key factors of success in each one of the extremely diverse industries shown under the banner “services”.

Chapter four is devoted to the growing trend of offshoring of corporate service functions. Offshoring has experienced a drastic change. It is no longer confined to outsourcing of unskilled repetitive manufacturing work. Today, the codification of jobs and information technology allow offshoring of knowledge-intensive work, e.g. sophisticated computer development, blood testing, x-ray diagnosis and R&D. These
new developments have caused increasing anxiety in the industrialized countries. It is claimed that no job is protected from an onslaught of competition from lower cost employees in India, China or CEE countries.

The Report distinguishes between captive offshoring and outsourcing. The first is executed within the network of a TNC. The latter is achieved by subcontracting to other firms. To date, a majority of offshoring is done by large TNCs, perhaps because of their competence in managing integrated operations; re-routing business operation offshore is a major undertaking that needs to be managed carefully. Most of offshoring operations are undertaken by the TNCs from the United States and the United Kingdom.

A concern about job losses triggered calls for protectionism. Lofty ideals of the need for economic liberalization are often forgotten when domestic interests are perceived as threatened and high-paid jobs are perceived as lost to lower wages countries. The Report lists, in chapter five, several attempts to limit offshoring by government agencies in developed countries or by private firms that currently receive government contracts. WIR04 concludes that developed countries will learn to adapt and that the concerns are likely to be unfounded: “[t]he final outcome should again be a win-win situation for the parties involved” (p. 216). The Report offers a careful and dispassionate analysis of the benefits and costs of these new developments. The crusaders against “loss of jobs” would benefit from reading such an objective analysis and may also benefit from the recognition of the facts. WIR04 points out (based on a McKinsey’s study) that, in 2001, Ireland enjoyed the highest share of offshoring – a quarter of the world market (p. 147). Four largest recipients – Ireland, India, Canada, Israel – accounted for over 71% of offshoring, mostly in various information technology-enables services. To be sure, the share of developing countries and CEE is increasing and the geographic scope for location of service FDI is broadening. Yet, several studies, quoted mainly in chapter five, show that the impact on employment in the two developed countries
accounting for 82% of offshoring – the United States and the United Kingdom – is minimal. Unfortunately, instead of recognizing the moves as a manifestation of a shift in comparative advantage, offshoring is sometimes presented as a zero-sum game resulting inevitably in job losses in developed countries.

International agreements covering both goods and services FDI are proliferating at the bilateral, regional and multilateral levels. The national and international policy challenges are analysed in Part Three of the Report – following and updating the discussion of the 2003 edition of the WIR. This part also focuses on services. The Report takes a macro view of many issues. For example, it does not discuss how to find a “development-oriented balance”. This is a challenge in any field, but much more so when services are discussed. Services are extremely heterogeneous, ranging over many diverse activities with different technologies and scope. The policy issues are poles apart, and their treatments cannot be the same for all types of services. Adding to these problems are the difficulties inherent in reaching a satisfactory legal definition of complex economic issues. Certainly, “strong, independent and regulatory structures are vital if the potential economic benefits of FDI are to be realized” (p. 141). The Report also stresses the need for maintaining flexibility (p. 236). This reviewer would add that it is essential to make sure that, if TNCs received incentives and concessions, these TNCs would deliver what was expected of them. Further, it is crucial to avoid costly beggar-thy-neighbour policy wars, including downward pressures on labour and environmental standards (Oman, 2001).

All in all, this annual publication is an extensive survey of the determinants and the drivers of FDI as well as the political and legal regimes in which they take place. It has justifiably become an essential research tool for all those interested in FDI. It is also of great practical value to decision-makers in both governments and TNCs. It supplies so many intriguing data and so many fascinating facts that no summary can capture its richness. Researchers of international business should certainly
read carefully the whole Report. It would have been easier to use this rich source of data if an index were added. Further, adding more references to scholarly work done outside the United Nations or other governmental organizations could enhance the hundreds of references presented in this publication.

Future publications might also include less ambiguous statements about the need to strike a development-oriented balance. This reviewer would like to see a careful analysis of the limits to globalization. One would hope that the Report would look at the links between private capital and governments, investigate the role of culture and examine the impact of technological changes. Future Reports should feel free to present views and assessments on the prospects for the future of TNCs and FDI. Furthermore, it would be nice to learn more on the reasons some industries are more global than others, why certain services become global while others lag behind and what the optimum balance between incentives to attract FDI and regulation to safeguard public interest is. Perhaps the Report could speculate about the impact of global integration on the possible reduction of differences in labour costs across countries as well as about the political, cultural and social dimensions of globalisation. Finally, it would be nice to see more attempts to offer facts, data and theories on the inner working of the TNCs and on the determinants of success of TNCs. This is a quite demanding wish list. Yet, high achievements of UNCTAD in the past allows one to expect that Organisation to meet even more difficult challenges.

Yair Aharoni
Professor Emeritus
Tel Aviv University
Israel