**Introduction**

Foreign direct investment (FDI) occurs when a firm invests directly in facilities to produce or market a good or service in a foreign country.

Once a firm undertakes FDI, it becomes a multinational enterprise. The investments by IKEA and Amazon in India that were discussed in the opening case are examples of FDI. This chapter begins by looking at the importance of FDI in the world economy. Next, we review the theories that have been used to explain why enterprises undertake foreign direct investment. The chapter then moves on to look at government policy toward foreign direct investment.

The chapter closes with a section on implications of the material discussed in the chapter for management practice.

**Foreign Direct Investment in the World Economy**

When discussing foreign direct investment, it is important to distinguish between the flow of FDI and the stock of FDI. The flow of FDI refers to the amount of FDI undertaken over a given time period (normally a year). The stock of FDI refers to the total accumulated value of foreign-owned assets at a given time. We also talk of outflows of FDI, meaning the flow of FDI out of a country, and inflows of FDI, the flow of FDI into a country.

**TRENDS IN FDI**

The past 25 years have seen a marked increase in both the flow and stock of FDI in the world economy. The average yearly outflow of FDI increased from $250 billion in 1990 to $1.59 trillion in 2016 (see Figure 8.1).1 Over the past 25 years, the flow of FDI has accelerated faster than the growth in world trade and world output.

As a result of the strong FDI flows, by 2016 the global stock of FDI was about $26 trillion. The foreign affiliates of multinationals had more than $36 trillion in global sales in 2016, compared to $21 trillion in global exports, and accounted for more than one-third of all cross-border trade in goods and services.3 Clearly, by any measure, FDI is a very important phenomenon in the global economy. FDI has grown more rapidly than world trade and world output for several reasons. First, despite the general decline in trade barriers over the past 30 years, firms still fear protectionist pressures. Executives see FDI as a way of circumventing future trade barriers. Given the rising pressures for protectionism associated with the election of Donald Trump as president in the United States and the decision by the British to leave the European Union, this seems likely to continue for some time. Second, much of the increase in FDI has been driven by the political and economic changes that have been occurring in many of the world’s developing nations. The general shift toward democratic political institutions and free market economies that we discussed in Chapter 3 has encouraged FDI. Across much of Asia, eastern Europe, and Latin America, economic growth, economic deregulation, privatization programs that are open to foreign investors, and removal of many restrictions on FDI have made these countries more attractive to foreign multinationals. According to the United Nations, some 90 percent of the 2,700 changes made worldwide between 1992 and 2009 in the laws governing foreign direct investment created a more favorable environment for FDI.4 The globalization of the world economy is also having a positive effect on the volume of FDI. Many firms see the whole world as their market, and they are undertaking FDI in an attempt to make sure they have a significant presence in many regions of the world. For example, a third of the revenues and as much as 40 percent of the profits of firms in the S&P 500 index are generated abroad. For reasons that we explore later in this book, many firms now believe it is important to have production facilities close to their major customers. This too creates pressure for greater FDI.

FIGURE 8.1 FDI outflows, 1990–2016 ($ billions).

**THE DIRECTION OF FDI**

Historically, most FDI has been directed at the developed nations of the world as firms based in advanced countries invested in the others’ markets (see Figure 8.2). FIGURE 8.2 FDI inflows by region, 1995–2016 ($ billions).

During the 1980s and 1990s, the United States was often the favorite target for FDI inflows. The United States has been an attractive target for FDI because of its large and wealthy domestic markets, its dynamic and stable economy, a favorable political environment, and the openness of the country to FDI. Investors include firms based in Great Britain, Japan, Germany, Holland, and France. Inward investment into the United States remained high during the 2000s and stood at $391 billion in 2016. The developed nations of Europe have also been recipients of significant FDI inflows, principally from the United States and other European nations. In 2016, inward investment into Europe was $532 billion. The United Kingdom and France have historically been the largest recipients of inward FDI.5 Even though developed nations still account for the largest share of FDI inflows, FDI into developing nations and the transition economies of eastern Europe and the old Soviet Union has increased markedly (see Figure 8.2). Most recent inflows into developing nations have been targeted at the emerging economies of Southeast Asia. Driving much of the increase has been the growing importance of China as a recipient of FDI, which attracted about $60 billion of FDI in 2004 and rose steadily to hit a record $134 billion in 2016.6 The reasons for the strong flow of investment into China are discussed in the accompanying Country Focus. Latin America is the next most important region in the developing world for FDI inflows. In 2016, total inward investments into this region reached $142 billion. Brazil has historically been the top recipient of inward FDI in Latin America. In Central America, Mexico has been a big recipient of inward investment thanks to its proximity to the United States and the NAFTA. In 2016, some $27 billion of investments were made by foreigners in Mexico. At the other end of the scale, Africa has long received the smallest amount of inward investment, $59 billion in 2016. In recent years, Chinese enterprises have emerged as major investors in Africa, particularly in extraction industries, where they seem to be trying to ensure future supplies of valuable raw materials. The inability of Africa to attract greater investment is in part a reflection of the political unrest, armed conflict, and frequent changes in economic policy in the region.7

**THE SOURCE OF FDI**

Since World War II, the United States has consistently been the largest source country for FDI. Other important source countries include the United Kingdom, France, Germany, the Netherlands, and Japan. Collectively, these six countries accounted for 60 percent of all FDI outflows for 1998–2016 (see Figure 8.3). As might be expected, these countries also predominate in rankings of the world’s largest multinationals.8 These nations dominate primarily because they were the most developed nations with the largest economies during much of the postwar period and therefore home to many of the largest and bestcapitalized enterprises. Many of these countries also had a long history as trading nations and naturally looked to foreign markets to fuel their economic expansion. Thus, it is no surprise that enterprises based there have been at the forefront of foreign investment trends. That being said, it is noteworthy that Chinese firms have started to emerge as major foreign investors.

**THE FORM OF FDI: ACQUISITIONS VERSUS GREENFIELD INVESTMENTS**

FDI takes on two main forms. The first is a greenfield investment, which involves the establishment of a new operation in a foreign country. The second involves acquiring or merging with an existing firm in the foreign country. UN estimates indicate that some 40 to 80 percent of all FDI inflows were in the form of mergers and acquisitions between 1998 and 2016.

When contemplating FDI, when do firms prefer to acquire existing assets rather than undertake greenfield investments? We consider this question in depth in Chapter 15. For now, we can make a few basic observations. First, mergers and acquisitions are quicker to execute than greenfield investments. This is an important consideration in the modern business world where markets evolve very rapidly. Many firms apparently believe that if they do not acquire a desirable target firm, then their global rivals will. Second, foreign firms are acquired because those firms have valuable strategic assets, such as brand loyalty, customer relationships, trademarks or patents, distribution systems, production systems, and the like. It is easier and perhaps less risky for a firm to acquire those assets than to build them from the ground up through a greenfield investment. Third, firms make acquisitions because they believe they can increase the efficiency of the acquired unit by transferring capital, technology, or management skills (see the Management Focus on Cemex for an example). However, as we discuss in Chapter 15, there is evidence that many mergers and acquisitions fail to realize their anticipated gains.

**Theories of Foreign Direct Investment**

In this section, we review several theories of foreign direct investment. These theories approach the various phenomena of foreign direct investment from three complementary perspectives. One set of theories seeks to explain why a firm will favor direct investment as a means of entering a foreign market when two other alternatives, exporting and licensing, are open to it. Another set of theories seeks to explain why firms in the same industry often undertake foreign direct investment at the same time and why they favor certain locations over others as targets for foreign direct investment. Put differently, these theories attempt to explain the observed pattern of foreign direct investment flows. A third theoretical perspective, known as the **eclectic paradigm**, attempts to combine the two other perspectives into a single holistic explanation of foreign direct investment (this theoretical perspective is eclectic because the best aspects of other theories are taken and combined into a single explanation).

**WHY FOREIGN DIRECT INVESTMENT?**

Why do firms go to the trouble of establishing operations abroad through foreign direct investment when two alternatives, exporting and licensing, are available to them for exploiting the profit opportunities in a foreign market? **Exporting** involves producing goods at home and then shipping them to the receiving country for sale. Licensing involves granting a foreign entity (the licensee) the right to produce and sell the firm’s product in return for a royalty fee on every unit sold. The question is important, given that a cursory examination of the topic suggests that foreign direct investment may be both expensive and risky compared with exporting and licensing. FDI is expensive because a firm must bear the costs of establishing production facilities in a foreign country or of acquiring a foreign enterprise. FDI is risky because of the problems associated with doing business in a different culture where the rules of the game may be very different. Relative to indigenous firms, there is a greater probability that a foreign firm undertaking FDI in a country for the first time will make costly mistakes due to its ignorance. When a firm exports, it need not bear the costs associated with FDI, and it can reduce the risks associated with selling abroad by using a native sales agent. Similarly, when a firm allows another enterprise to produce its products under license, the licensee bears the costs or risks (e.g., fashion retailer Burberry originally entered Japan via a licensing contract with a Japanese retailer). So why do so many firms apparently prefer FDI over either exporting or licensing? The answer can be found by examining the limitations of exporting and licensing as means for capitalizing on foreign market opportunities.

**Limitations of Exporting**

The viability of exporting physical goods is often constrained by transportation costs and trade barriers. When transportation costs are added to production costs, it becomes unprofitable to ship some products over a large distance. This is particularly true of products that have a low value-to-weight ratio and that can be produced in almost any location. For such products, the attractiveness of exporting decreases, relative to either FDI or licensing. This is the case, for example, with cement. Thus, Cemex, the large Mexican cement maker, has expanded internationally by pursuing FDI, rather than exporting (see the accompanying Management Focus). For products with a high value-to-weight ratio, however, transportation costs are normally a minor component of total landed cost (e.g., electronic components, personal computers, medical equipment, computer software, etc.) and have little impact on the relative attractiveness of exporting, licensing, and FDI. Transportation costs aside, some firms undertake foreign direct investment as a response to actual or threatened trade barriers such as import tariffs or quotas. By placing tariffs on imported goods, governments can increase the cost of exporting relative to foreign direct investment and licensing. Similarly, by limiting imports through quotas, governments increase the attractiveness of FDI and licensing.

**Limitations of Licensing**

A branch of economic theory known as internalization theory seeks to explain why firms often prefer foreign direct investment over licensing as a strategy for entering foreign markets (this approach is also known as the market imperfections approach).12 According to internalization theory, licensing has three major drawbacks as a strategy for exploiting foreign market opportunities. First, licensing may result in a firm’s giving away valuable technological know-how to a potential foreign competitor.

A second problem is that licensing does not give a firm the tight control over production, marketing, and strategy in a foreign country that may be required to maximize its profitability. With licensing, control over production (of a good or a service), marketing, and strategy are granted to a licensee in return for a royalty fee. However, for both strategic and operational reasons, a firm may want to retain control over these functions. One reason for wanting control over the strategy of a foreign entity is that a firm might want its foreign subsidiary to price and market very aggressively as a way of keeping a foreign competitor in check.

.Another reason for wanting control over the strategy of a foreign entity is to make sure that the entity does not damage the firm’s brand.

One reason for wanting control over the operations of a foreign entity is that the firm might wish to take advantage of differences in factor costs across countries, producing only part of its final product in a given country, while importing other parts from where they can be produced at lower cost.

A third problem with licensing arises when the firm’s competitive advantage is based not as much on its products as on the management, marketing, and manufacturing capabilities that produce those products. The problem here is that such capabilities are often not amenable to licensing. While a foreign licensee may be able to physically reproduce the firm’s product under license, it often may not be able to do so as efficiently as the firm could itself. As a result, the licensee may not be able to fully exploit the profit potential inherent in a foreign market.

These kinds of skills are difficult to articulate or codify; they certainly cannot be written down in a simple licensing contract. They are organization-wide and have been developed over the years. They are not embodied in any one individual but instead are widely dispersed throughout the company.

All of this suggests that when one or more of the following conditions holds, markets fail as a mechanism for selling know-how and FDI is more profitable than licensing:

(1)when the firm has valuable know-how that cannot be adequately protected by a licensing contract, (2) when the firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and (3) when a firm’s skills and know-how are not amenable to licensing.

**Advantages of Foreign Direct Investment**

It follows that a firm will favor foreign direct investment over exporting as an entry strategy when transportation costs or trade barriers make exporting unattractive. Furthermore, the firm will favor foreign direct investment over licensing (or franchising) when it wishes to maintain control over its technological know-how, or over its operations and business strategy, or when the firm’s capabilities are simply not amenable to licensing, as may often be the case.

**THE PATTERN OF FOREIGN DIRECT INVESTMENT**

**Strategic Behavior**

One theory is based on the idea that FDI flows are a reflection of strategic rivalry between firms in the global marketplace. An early variant of this argument was expounded by F. T. Knickerbocker, who looked at the relationship between FDI and rivalry in oligopolistic industries.14 **An oligopoly** is an industry composed of a limited number of large firms (e.g., an industry in which four firms control 80 percent of a domestic market would be defined as an oligopoly). A critical competitive feature of such industries is interdependence of the major players: What one firm does can have an immediate impact on the major competitors, forcing a response in kind. By cutting prices, one firm in an oligopoly can take market share away from its competitors, forcing them to respond with similar price cuts to retain their market share. Thus, the interdependence between firms in an oligopoly leads to imitative behavior; rivals often quickly imitate what a firm does in an oligopoly. Imitative behavior can take many forms in an oligopoly. One firm raises prices, and the others follow; one expands capacity, and the rivals imitate lest they be left at a disadvantage in the future. Knickerbocker argued that the same kind of imitative behavior characterizes FDI.

Knickerbocker’s theory can be extended to embrace the concept of multipoint competition. **Multipoint competition** arises when two or more enterprises encounter each other in different regional markets, national markets, or industries.18 Economic theory suggests that rather like chess players jockeying for advantage, firms will try to match each other’s moves in different markets to try to hold each other in check. The idea is to ensure that a rival does not gain a commanding position in one market and then use the profits generated there to subsidize competitive attacks in other markets.

**THE ECLECTIC PARADIGM**

The eclectic paradigm has been championed by the late British economist John Dunning.19 Dunning argues that in addition to the various factors discussed earlier, location-specific advantages are also of considerable importance in explaining both the rationale for and the direction of foreign direct investment. By **location-specific advantages**, Dunning means the advantages that arise from utilizing resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets (such as the firm’s technological, marketing, or management capabilities). Dunning accepts the argument of internalization theory that it is difficult for a firm to license its own unique capabilities and know-how. Therefore, he argues that combining location-specific assets or resource endowments with the firm’s own unique capabilities often requires foreign direct investment. That is, it requires the firm to establish production facilities where those foreign assets or resource endowments are located.

In Dunning’s language, this means that Silicon Valley has a location-specific advantage in the generation of knowledge related to the computer and semiconductor industries. In part, this advantage comes from the sheer concentration of intellectual talent in this area, and in part, it arises from a network of informal contacts that allows firms to benefit from each other’s knowledge generation. Economists refer to such knowledge “spillovers” as externalities, and there is a wellestablished theory suggesting that firms can benefit from such externalities by locating close to their source.

**Political Ideology and Foreign Direct Investment**

Historically, political ideology toward FDI within a nation has ranged from a dogmatic radical stance that is hostile to all inward FDI at one extreme to an adherence to the noninterventionist principle of free market economics at the other. Between these two extremes is an approach that might be called pragmatic nationalism.

**THE RADICAL VIEW**

The radical view traces its roots to Marxist political and economic theory. Radical writers argue that the multinational enterprise (MNE) is an instrument of imperialist domination. They see the MNE as a tool for exploiting host countries to the exclusive benefit of their capitalist–imperialist home countries. They argue that MNEs extract profits from the host country and take them to their home country, giving nothing of value to the host country in exchange.

Thus, according to the extreme version of this view, no country should ever permit foreign corporations to undertake FDI because they can never be instruments of economic development, only of economic domination.

**THE FREE MARKET VIEW**

The free market view traces its roots to classical economics and the international trade theories of Adam Smith and David Ricardo (see Chapter 6). The intellectual case for this view has been strengthened by the internalization explanation of FDI. The free market view argues that international production should be distributed among countries according to the theory of comparative advantage. Countries should specialize in the production of those goods and services that they can produce most efficiently. Within this framework, the MNE is an instrument for dispersing the production of goods and services to the most efficient locations around the globe.

**PRAGMATIC NATIONALISM**

In practice, many countries have adopted neither a radical policy nor a free market policy toward FDI but, instead, a policy that can best be described as pragmatic nationalism.26 The pragmatic nationalist view is that FDI has both benefits and costs. FDI can benefit a host country by bringing capital, skills, technology, and jobs, but those benefits come at a cost. When a foreign company rather than a domestic company produces products, the profits from that investment go abroad. Many countries are also concerned that a foreignowned manufacturing plant may import many components from its home country, which has negative implications for the host country’s balance-of-payments position. Recognizing this, countries adopting a pragmatic stance pursue policies designed to maximize the national benefits and minimize the national costs. According to this view, FDI should be allowed so long as the benefits outweigh the costs.

**SHIFTING IDEOLOGY**

Recent years have seen a marked decline in the number of countries that adhere to a radical ideology. Although few countries have adopted a pure free market policy stance, an increasing number of countries are gravitating toward the free market end of the spectrum and have liberalized their foreign investment regime.

As a counterpoint, there is some evidence of a shift to a more hostile approach to foreign direct investment in some nations.

**Benefits and Costs of FDI**

To a greater or lesser degree, many governments can be considered pragmatic nationalists when it comes to FDI.

**HOST-COUNTRY BENEFITS**

The main benefits of inward FDI for a host country arise from resource-transfer effects, employment effects, balance-of-payments effects, and effects on competition and economic growth. Resource-Transfer Effects Foreign direct investment can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available and thus boost that country’s economic growth rate. With regard to capital, many MNEs, by virtue of their large size and financial strength, have access to financial resources not available to host-country firms. These funds may be available from internal company sources, or, because of their reputation, large MNEs may find it easier to borrow money from capital markets than host-country firms would. As for technology, you will recall from Chapter 3 that technology can stimulate economic development and industrialization. Technology can take two forms, both of which are valuable. Technology can be incorporated in a production process (e.g., the technology for discovering, extracting, and refining oil), or it can be incorporated in a product (e.g., personal computers). However, many countries lack the research and development resources and skills required to develop their own indigenous product and process technology. This is particularly true in less developed nations. Such countries must rely on advanced industrialized nations for much of the technology required to stimulate economic growth, and FDI can provide it. Research supports the view that multinational firms often transfer significant technology when they invest in a foreign country.

Foreign management skills acquired through FDI may also produce important benefits for the host country. Foreign managers trained in the latest management techniques can often help improve the efficiency of operations in the host country, whether those operations are acquired or greenfield developments.

**Employment Effects**

Another beneficial employment effect claimed for FDI is that it brings jobs to a host country that would otherwise not be created there. The effects of FDI on employment are both direct and indirect. Direct effects arise when a foreign MNE employs a number of hostcountry citizens. Indirect

effects arise when jobs are created in local suppliers as a result of the investment and when jobs are created because of increased local spending by employees of the MNE.

**Balance-of-Payments Effects**

FDI’s effect on a country’s balance-of-payments accounts is an important policy issue for most host governments. A country’s balance-of-payments accounts track both its payments to and its receipts from other countries. Governments normally are concerned when their country is running a deficit on the current account of their balance of payments. The current account tracks the export and import of goods and services. A current account deficit, or trade deficit as it is often called, arises when a country is importing more goods and services than it is exporting. Governments typically prefer to see a current account surplus rather than a deficit. The only way in which a current account deficit can be supported in the long run is by selling off assets to foreigners (for a detailed explanation of why this is the case, see the appendix to Chapter 6).

First, if the FDI is a substitute for imports of goods or services, the effect can be to improve the current account of the host country’s balance of payments.

A second potential benefit arises when the MNE uses a foreign subsidiary to export goods and services to other countries.

**Effect on Competition and Economic Growth**

Economic theory tells us that the efficient functioning of markets depends on an adequate level of competition between producers. When FDI takes the form of a greenfield investment, the result is to establish a new enterprise, increasing the number of players in a market and thus consumer choice. In turn, this can increase the level of competition in a national market, thereby driving down prices and increasing the economic welfare of consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment, and R&D as they struggle to gain an edge over their rivals. The long-term results may include increased productivity growth, product and process innovations, and greater economic growth.

FDI’s impact on competition in domestic markets may be particularly important in the case of services, such as telecommunications, retailing, and many financial services, where exporting is often not an option because the service has to be produced where it is delivered.35

**HOST-COUNTRY COSTS**

Three costs of FDI concern host countries. They arise from possible adverse effects on competition within the host nation, adverse effects on the balance of payments, and the perceived loss of national sovereignty and autonomy.

**Adverse Effects on Competition**

Host governments sometimes worry that the subsidiaries of foreign MNEs may have greater economic power than indigenous competitors. If it is part of a larger international organization, the foreign MNE may be able to draw on funds generated elsewhere to subsidize its costs in the host market, which could drive indigenous companies out of business and allow the firm to monopolize the market. Once the market is monopolized, the foreign MNE could raise prices above those that would prevail in competitive markets, with harmful effects on the economic welfare of the host nation. This concern tends to be greater in countries that have few large firms of their own (generally, less developed countries). It tends to be a relatively minor concern in most advanced industrialized nations.

**Adverse Effects on the Balance of Payments**

The possible adverse effects of FDI on a host country’s balance-of-payments position are twofold. First, set against the initial capital inflow that comes with FDI must be the subsequent outflow of earnings from the foreign subsidiary to its parent company. Such outflows show up as capital outflow on balance-of-payments accounts. Some governments have responded to such outflows by restricting the amount of earnings that can be repatriated to a foreign subsidiary’s home country. A second concern arises when a foreign subsidiary imports a substantial number of its inputs from abroad, which results in a debit on the current account of the host country’s balance of payments.

**Possible Effects on National Sovereignty and Autonomy**

Some host governments worry that FDI is accompanied by some loss of economic independence. The concern is that key decisions that can affect the host country’s economy will be made by a foreign parent that has no real commitment to the host country and over which the host country’s government has no real control. Most economists dismiss such concerns as groundless and irrational.

**HOME-COUNTRY BENEFITS**

The benefits of FDI to the home (source) country arise from three sources. First, the home country’s balance of payments benefits from the inward flow of foreign earnings. FDI can also benefit the home country’s balance of payments if the foreign subsidiary creates demands for home-country exports of capital equipment, intermediate goods, complementary products, and the like. Second, benefits to the home country from outward FDI arise from employment effects. As with the balance of payments, positive employment effects arise when the foreign subsidiary creates demand for home-country exports. Thus, Toyota’s investment in auto assembly operations in Europe has benefited both the Japanese balance-of-payments position and employment in Japan, because Toyota imports some component parts for its European-based auto assembly operations directly from Japan. Third, benefits arise when the home-country MNE learns valuable skills from its exposure to foreign markets that can subsequently be transferred back to the home country. This amounts to a reverse resource-transfer effect. Through its exposure to a foreign market, an MNE can learn about superior management techniques and superior product and process technologies. These resources can then be transferred back to the home country, contributing to the home country’s economic growth rate.38

**HOME-COUNTRY COSTS**

Against these benefits must be set the apparent costs of FDI for the home (source) country. The most important concerns center on the balance-of-payments and employment effects of outward FDI. The home country’s balance of payments may suffer in three ways. First, the balance of payments suffers from the initial capital outflow required to finance the FDI. This effect, however, is usually more than offset by the subsequent inflow of foreign earnings. Second, the current account of the balance of payments suffers if the purpose of the foreign investment is to serve the home market from a low-cost production location. Third, the current account of the balance of payments suffers if the FDI is a substitute for direct exports. Thus, insofar as Toyota’s assembly operations in the United States are intended to substitute for direct exports from Japan, the current account position of Japan will deteriorate.

**INTERNATIONAL TRADE THEORY AND FDI**

When assessing the costs and benefits of FDI to the home country, keep in mind the lessons of international trade theory (see Chapter 6). International trade theory tells us that home-country concerns about the negative economic effects of offshore production may be misplaced. The term offshore production refers to FDI undertaken to serve the home market.

Under such a scenario, the adverse longrun economic effects for a country would probably outweigh the relatively minor balanceof-payments and employment effects associated with offshore production.

**HOME-COUNTRY POLICIES**

Through their choice of policies, home countries can both encourage and restrict FDI by local firms. We look at policies designed to encourage outward FDI first. These include foreign risk insurance, capital assistance, tax incentives, and political pressure. Then we look at policies designed to restrict outward FDI.

**Encouraging Outward FDI**

Many investor nations now have government-backed insurance programs to cover major types of foreign investment risk. The types of risks insurable through these programs include the risks of expropriation (nationalization), war losses, and the inability to transfer profits back home. Such programs are particularly useful in encouraging firms to undertake investments in politically unstable countries.40 In addition, several advanced countries also have special funds or banks that make government loans to firms wishing to invest in developing countries. As a further incentive to encourage domestic firms to undertake FDI, many countries have eliminated double taxation of foreign income (i.e., taxation of income in both the host country and the home country). Last, and perhaps most significant, a number of investor countries (including the United States) have used their political influence to persuade host countries to relax their restrictions on inbound FDI.

**Restricting Outward FDI**

Virtually all investor countries, including the United States, have exercised some control over outward FDI from time to time. One policy has been to limit capital outflows out of concern for the country’s balance of payments.

In addition, countries have occasionally manipulated tax rules to try to encourage their firms to invest at home. The objective behind such policies is to create jobs at home rather than in other nations.

Finally, countries sometimes prohibit national firms from investing in certain countries for political reasons. Such restrictions can be formal or informal.

**HOST-COUNTRY POLICIES**

**Encouraging Inward FDI**

It is common for governments to offer incentives to foreign firms to invest in their countries. Such incentives take many forms, but the most common are tax concessions, low- interest loans, and grants or subsidies. Incentives are motivated by a desire to gain from the resource-transfer and employment effects of FDI. They are also motivated by a desire to capture FDI away from other potential host countries.

**Restricting Inward FDI**

Host governments use a wide range of controls to restrict FDI in one way or another. The two most common are ownership restraints and performance requirements. Ownership restraints can take several forms. In some countries, foreign companies are excluded from specific fields. They are excluded from tobacco and mining in Sweden and from the development of certain natural resources in Brazil, Finland, and Morocco. In other industries, foreign ownership may be permitted although a significant proportion of the equity of the subsidiary must be owned by local investors.

The rationale underlying ownership restraints seems to be twofold. First, foreign firms are often excluded from certain sectors on the grounds of national security or competition. Particularly in less developed countries, the feeling seems to be that local firms might not be able to develop unless foreign competition is restricted by a combination of import tariffs and controls on FDI. This is a variant of the infant industry argument discussed in Chapter 7. Second, ownership restraints seem to be based on a belief that local owners can help maximize the resource-transfer and employment benefits of FDI for the host country. Until the 1980s, the Japanese government prohibited most FDI but allowed joint ventures between Japanese firms and foreign MNEs if the MNE had a valuable technology. The Japanese government clearly believed such an arrangement would speed up the subsequent diffusion of the MNE’s valuable technology throughout the Japanese economy. Performance requirements can also take several forms. Performance requirements are controls over the behavior of the MNE’s local subsidiary. The most common performance requirements are related to local content, exports, technology transfer, and local participation in top management. As with certain ownership restrictions, the logic underlying performance requirements is that such rules help maximize the benefits and minimize the costs of FDI for the host country. Many countries employ some form of performance requirements when it suits their objectives. However, performance requirements tend to be more common in less developed countries than in advanced industrialized nations.42

**INTERNATIONAL INSTITUTIONS AND THE LIBERALIZATION OF FDI**

Until the 1990s, there was no consistent involvement by multinational institutions in the governing of FDI. This changed with the formation of the World Trade Organization in 1995. The WTO embraces the promotion of international trade in services. Because many services have to be produced where they are sold, exporting is not an option (e.g., one cannot export McDonald’s hamburgers or consumer banking services). Given this, the WTO has become involved in regulations governing FDI. As might be expected for an institution created to promote free trade, the thrust of the WTO’s efforts has been to push for the liberalization of regulations governing FDI, particularly in services. Under the auspices of the WTO, two extensive multinational agreements were reached in 1997 to liberalize trade in telecommunications and financial services.