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**ENHANCING THE CONTRIBUTION OF FOREIGN DIRECT
INVESTMENT TO DEVELOPMENT**

**A NEW AGENDA FOR THE CORPORATE SOCIAL RESPONSIBILITY
COMMUNITY, INTERNATIONAL LABOR AND CIVIL SOCIETY, AID
DONORS, AND MULTILATERAL FINANCIAL INSTITUTIONS**

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Introduction

This chapter summarizes new insights about the relationship between foreign direct investment (FDI) and development, with the aim of offering a fresh perspective for the corporate social responsibility community, international labor and civil society, aid donors, and multilateral financial institutions.¹ The target for this chapter is an audience that I shall label, awkwardly, *the pro-poor sustainable development policy community*.² The common aim of this pro-poor sustainable development policy community, I postulate, is to maximize the contribution of foreign direct investment to the long-term economic and social welfare of the largest number of people in the developing world.

Developing country policymakers retain the principal responsibility for formulating policies toward FDI. But there are many economic and social obstacles to the formation of optimal host country policies, and -- as this chapter will make clear -- external action beyond what host country policymakers can accomplish on their own is often needed to capture the benefits of foreign direct investment and minimize the costs or avoid the damages. This leaves important tasks that need to be performed by outside members within the pro-poor sustainable development community.

The evidence summarized here diverges from the widely-criticized Washington Consensus (that “FDI is good, and the more the better”) in fundamental ways. The analysis shows that both positive contributions and negative damages from FDI are greater than even the most sophisticated of today’s models and estimating techniques portray. Securing these positive contributions while avoiding the negative damages requires strategies to correct for market failures, to supply public goods and international standards, to capture positive externalities and escape negative externalities. Here is where action by international civil society, corporate social responsibility advocates, international donors, and multilateral lenders is vitally needed. In this paper, I shall make the somewhat novel argument that members of the pro-poor sustainable development policy community should more closely fashion their agenda to provide those external

¹ This chapter draws upon my upcoming book, *Foreign Direct Investment and Development: Launching a Second Generation of Policy Research, Avoiding the Mistakes of the First* (Washington, DC: Peterson Institute of International Economics, forthcoming 2010). I wish to thank John Kline, Karin Lissakers, and Gerald West for helpful comments.

² As explained later, the new agenda proposed here is intended to cover all those interested in socially responsible investing, social investing, mission-driven investing, sustainable and responsible investing, blended value investing, values based investing, mission-related investing, ethical investing, responsible investing, impact investing, program related investing, triple bottom line investing, and environmental, social, and governance investing.

pressures and actions needed *to enhance the impact of main-line multinational corporate activities* on host country growth and welfare.

I call this a “somewhat novel” approach since in some areas – most notably the Extractive Industry Transparency Initiative (EITI and EITI + +) and associated anti-corruption and environmental protection efforts – corporate social responsibility supporters, international civil society organizations and local NGOs, aid donors, and multilateral financial institutions are well advanced along the lines advocated here. But even in the arena of the Extractive Industry Transparency Initiative I shall show that new actions and subtle modifications are needed.

This approach is also “somewhat novel” because it may appear to be rather dismissive of simply applying pressure on multinational corporations to “give back” more to the communities where they operate, or to treat their workers better. This is not because clinics, and schools, and social welfare projects are a bad idea, or because good labor standards are not important, but because **conventional CSR preoccupations should not substitute for actions to enhance the larger contributions that well-structure, well-managed main-line FDI activities can make to pro-poor sustainable development, nor divert attention from the harmful consequences of poorly-structured and poorly-managed FDI activities even when surrounded by nice schools and clinics and relatively clean environments.** I recognize that I am not the first analyst to be skeptical of mere multinational corporate philanthropy, but I hope to provide fresh insight into what is needed to enhance the contribution of foreign direct investment to the long-term economic and social welfare of the largest number of people in the developing world on the part of those who want to “do good”.

A. A Fresh Look at the Relationship between Foreign Direct Investment and Development

The research project that underpins the analysis offered here has generated insights in seven areas that might be useful for shaping the agenda of external actors who populate the *pro-poor sustainable development policy community*.

1. FDI in Different Sectors Pose Distinctive Challenges.

The first insight is the most obvious: the challenges associated with optimizing the contribution of foreign direct investment to development differ dramatically depending upon the sector: FDI in natural resources, FDI in infrastructure, FDI in agribusiness and horticulture, FDI in manufacturing, and FDI in services.³ The public policies and societal

³ To be sure, each of these categories of FDI can be further subdivided – in particular low-skilled manufacturing such as garments and footwear, and higher-skilled

pressures needed to produce beneficial development outcomes diverge in fundamental ways, and strategies to produce favorable outcomes (and avoid disastrous results) need to be devised separately. The starting point in fashioning an agenda for the *pro-poor sustainable development policy community* therefore is to understand each type of FDI on its own terms. It makes no sense to jumble recommendations for how to deal with FDI in Nigerian oil, FDI in Argentine electricity, FDI in Kenyan cut flowers, FDI in Honduran sweatshops, FDI in Malaysian disk drive plants, and FDI in Mexican retail chains.

From an analytical point of view, moreover, mixing data, and trying to come to overarching conclusions about how one phenomenon (“foreign direct investment”) affects another (“development” or “growth”) is likely to lead to mistakes and errors. Many of the best known studies – such as the widely cited article on “How Does Foreign Direct Investment Affect Economic Growth?” by E. Borensztein, J. De Gregorio and J. W. Lee – get into trouble by combining FDI data from all sectors into one single variable.⁴ The Borensztein team concluded that FDI can have a positive impact on economic growth only when the host country already surpasses a certain human resource threshold, despite abundant evidence elsewhere (see *infra*) that manufacturing FDI can bring substantial benefits to even poorest host economies. The Borensztein result probably derives from the fact that their FDI measure in low human resource countries is dominated by extractive sector investment.⁵ The policy reader of the Borensztein article might conclude that attraction of FDI in manufacturing and assembly for poorest states, and external market access for manufactured exports from poorest states, were not worthwhile endeavors, whereas (as noted later) just the opposite is the appropriate conclusion.

In general, the differences between these kinds of FDI are sufficiently great that studies that mix all types together to find the impact of foreign direct investment on host country welfare, or growth, simply have to be discarded, and redone. The list of studies whose usefulness must now be questioned includes many distinguished names: V. N. Balasubramanyam, M. Salisu, and David Sapsford (1996)⁶; E. Borensztein, J. De

manufacturing such as semiconductors and disk drives, as the subsequent text will point out.

⁴ E. Borensztein, J. De Gregorio, and J. W. Lee, “How Does Foreign Direct Investment Affect Economic Growth?,” *Journal of International Economics* 45 no. 1 (June, 1998), pp. 115-135.

⁵ It is not possible to discern exactly what kind of FDI is included in the flows into the low human resource countries in the Borensztein *et al.* study.

⁶ V. N. Balasubramanyam, M. Salisu, and David Sapsford, “Foreign Direct Investment and Growth in EP and IS Countries,” *The Economic Journal* 106, (434), (January, 1996), pp. 92-105.

Gregorio and J. W. Lee (1998)⁷; Barry P. Bosworth and Susan M. Collins, (1999)⁸; Luis De Mello (1999)⁹; Jon D. Haveman, Vivian Lei, and Janet S. Netz (2001)¹⁰; Helmut Reisen and Marcelo Soto (2001)¹¹; Niels Hermes and Robert Lensink (2003)¹²; Jong Choe II (2003)¹³; Maria Carkovic and Ross Levine (2005)¹⁴; Bruce Blonigan and Miao Grace Wang (2005)¹⁵; Robert Lensink and Oliver Morrissey (2006)¹⁶, among others. .

⁷ Borensztein, De Gregorio, and Lee, “How Does Foreign Direct Investment Affect Economic Growth?,” *op. cit.*

⁸ Bosworth, Barry P. and Susan M. Collins, “Capital Flows to Developing Economies: Implications for Saving and Investment,” *Brookings Papers on Economic Activity: 1*, Brookings Institution (1999). And “The Empirics of Growth: An Update,” *Brookings Papers on Economic Activity: 2*, (Washington, DC: Brookings Institution 2003).

⁹ Luiz De Mello, “Foreign Direct Investment-Led Growth: Evidence from Time Series and Panel Data,” *Oxford Economic Papers* Vol. 51, No. 1 (January 1999), pp. 133-51.

¹⁰ Jon D. Haveman, Vivian Lei, and Janet S. Netz, “International Integration and Growth: A Survey and Empirical Investigation,” *Review of Development Economics* Vol. 5, No. 2 (June 2001), pp. 289-311.

¹¹ Helmut Reisen and Marcelo Soto, “Which Types of Capital Inflows Foster Developing-Country Growth?,” *International Finance* Vol. 4, No. 1 (Spring 2001), pp. 1-14.

¹² Hermes, Niels, and Robert Lensink, “Foreign Direct Investment, Financial Development and Economic Growth,” *Journal of Development Studies* Vol. 40, No. 1 (October 2003), pp. 142-63.

¹³ Jong II Choe, “Do Foreign Direct Investment and Gross Domestic Investment Promote Economic Growth?,” *Review of Development Economics* Vol. 7, No. 1 (February 2003), pp. 44-57.

¹⁴ Maria Carkovic and Ross Levine. “Does Foreign Direct Investment Accelerate Economic Growth?,” in Theodore H. Moran, Edward M. Graham, and Magnus Blomström, eds., *Does Foreign Direct Investment Promote Development?* (Washington, DC: Peterson Institute for International Economics, Center for Global Development, 2005).

¹⁵ Bruce A. Blonigan and Miao Grace Wang. “Inappropriate Pooling of Wealthy and Poor Countries in Empirical FDI Studies,” in Theodore H. Edward M. Graham, and Magnus Blomström, eds., *Does Foreign Direct Investment Promote Development?* (Washington, DC: Peterson Institute for International Economics, Center for Global Development, 2005).

¹⁶ Robert Lensink, and Oliver Morrissey, “Foreign Direct Investment: Flows, Volatility and the Impact on Growth,” *Review of International Economics*, (2005). And, Helmut

This paper will concentrate on FDI in the extractive sector, and FDI in manufacturing – and even in the latter it will be important to separate FDI in low-skill activities like garments and footwear from FDI in higher-skill activities like auto parts and computers.

2. Is FDI in natural resources a “curse”?

After separating FDI into distinct types, the second insight is also straightforward: a rich natural resource endowment can indeed be a curse, but need not be such.¹⁷

In aggregate terms, the finding that natural resource abundance is associated with lower than expected national growth rates is highly sensitive to the time period selected, and shows numerous counter-trend examples.¹⁸ The negative outcomes in Equatorial Guinea, Democratic Republic of Congo, Angola, and Nigeria are countered by positive developmental impacts in Chile, Brazil, Colombia, Argentina, Indonesia, Malaysia, and Botswana. The specific problems associated with “Dutch disease” have proved readily manageable with appropriate macroeconomic policies.¹⁹

The difference between negative outcomes and positive outcomes from FDI in natural resources centers on the well-established need for transparency in revenue streams, for controls to prevent corruption, and for measures to set and enforce best-practice environmental standards.²⁰ Dealing with the “resource curse” has become the model for

Reisen and Marcelo Soto, “Which Types of Capital Inflows Foster Developing-Country Growth?,” *International Finance* Vol. 4, No. 1 (Spring 2001), pp. 1-14.

¹⁷Richard M. Auty, *Patterns of Development: Resources, Policy and Economic Growth* (London: Edward Arnold, 1994). Jeffrey D. Sachs and Andrew M. Warner, “Natural resources and economic development: the curse of natural resources,” *European Economic Review* 45 (2001), pp. 827-838.

¹⁸Daniel Lederman and William Maloney, “Trade structure and growth,” *World Bank Working Paper* (Washington, DC: The World Bank, November, 2003). Gavin Wright and Jesse Czelusta, “The Myth of the Resource Curse,” *Challenge* 47(2) (2004). pp. 6-38. See also Paul Stevens. “Resource impact: Curse or blessing? (A literature survey),” *Journal of Energy Literature* 9(1) (2003), pp. 3-42.

¹⁹Graham A. Davis and John E. Tilton, “The Resource Curse”. *Natural Resources Forum* 29 (2005) 233-242. Graham A. Davis, “Learning to Love the Dutch Disease: Evidence from the Mineral Economies,” *World Development* Vol. 23, No. 10, (1995), pp. 1765-1779.

²⁰*World Investment Report 2007: Transnational Corporations, Extractive Industries, and Development*, (New York: United Nations Conference on Trade and Development, (UNCTAD), 2007).

demonstrating that extra-market forces are needed to enable developing countries to optimize the gains from foreign direct investment: multilateral institutions like the World Bank must work with industry groups, environmental NGOs, and others to set common standards for dealing with the environment and rights of indigenous people, and to fund capacity-building for official enforcement and civil society monitoring. The Extractive Industry Transparency Initiative is advancing the norm of publication and verification of investor payments and government revenues from oil, gas, and mining.²¹ Additional NGOs (Publish What You Pay, Revenue Watch Institute, Transparency International, Oxfam, and Global Witness, and others) help with capacity building for host officials, host legislators, and local NGOs auditors, and keep watch over outcomes. The EITI ++ agenda of the World Bank aims to provide technical assistance, backed by a Trust Fund, for all aspects of resource management.²² As the upcoming exploitation of new oil discoveries in Ghana illustrates, the need for external support to ensure good governance of FDI in natural resources is not limited to the poorest states – an observation that will be important later in discussing whether the World Bank and regional development banks continue to have a role to play in middle-income developing countries.²³

But the EITI ++ endeavor is still a work in progress, requiring specific country commitments and timetables covering investors of all nationalities (OECD and non-OECD), backed by measures to validate performance by the EITI secretariat. Thirty seven of the largest oil, gas, and mining companies have committed themselves to support the EITI, but many still oppose company-by-company reports of payments to the government. The reality is that company-by-company reports will ultimately benefit the most conscientious investors, by forcing all participants (including those from Russia, China, India, and elsewhere) to subject themselves to equal transparency. The Majority of international resource investors (including those that appose disaggregation) recognize that concerns that individual company disclosure would be commercially disadvantageous are in reality extremely minor or non-existent, and no company involved in disaggregated payment disclosure has later had its contract cancelled or renegotiated as a result.²⁴ Socially responsible investors should support company-by-company reports in their own self-interest. Extractive industry investors can also play a powerful role in persuading new host authorities to join wholeheartedly in the EITI process.

My research shows, however, that optimizing the contribution of FDI in petroleum and minerals to development requires three somewhat controversial extra additions to the

²¹EITI (Extractive Industry Transparency Initiative) <http://eitransparency.org/>

²²EITI Plus (Extractive Industry Transparency Initiative Plus Plus), <http://web.www.worldbank.org>.

²³The Government of Norway, IMF, World Bank, and Oxfam – among others – are advising Ghana on preparations for management of oil income.

²⁴ *Ibid*, p. 22, p. 27. *Toward Strengthened EITI Reporting – Summary Report and Recommendations, op. cit.* pp. 3-4.

EITI ++ agenda. The first is a need for external assistance in negotiating and (perhaps) renegotiating extractive industry FDI contracts. The World Bank Group and regional development bank already provide guarantees, insurance, and dispute settlement processes that help ensure contract stability. It is now becoming clear that the mantra that contract negotiations should be regarded as private undertakings between international corporations and host governments whereas enforcing the contracts is a public good is not sustainable.²⁵ Multilateral financial institutions, bilateral assistance agencies, and international civil society groups need to provide assistance akin to the support for renegotiating extractive sector contracts – and bringing transfer pricing into line – in Liberia after the election of President Ellen Johnson Sirleaf.²⁶

Second, as part of an expanded EITI ++ agenda, multilateral training and support programs need to guide host countries to place greater emphasis on progressive taxes (income taxes) rather than regressive taxes (royalties and production sharing agreements).²⁷ This recommendation may take some in the *pro-poor sustainable development policy community* by surprise since such an approach generally means lower up-front payments to the host government while the foreign investor recovers the initial investment. But progressive taxes (even with higher tax rates) make the attraction of FDI into the extractive sector easier, and – most importantly – allow host authorities to benefit more fully when oil, natural gas, and mineral prices rise. The top ten foreign-owned mining companies in Chile paid taxes of \$2.1 billion from 1991 to 2003, in contrast to payments on \$9.7 billion on the part of the two state-owned mining companies, despite greater output and lower costs, principally because they subtracted accelerated depreciation on new properties.²⁸ When accelerated depreciation finished, one foreign-owned mine alone (Escondida) climbed from almost no tax payments to \$423 million in 2004. As a practical matter, most developing countries will simply not want to wait five

²⁵Daniel Dumas, Head of Economic and Legal Section, Commonwealth Secretariat. “Extractive Industries Week: Improving Extractive Industries Benefits for the Poor,” (Washington, DC: The World Bank, March 4, 2009).

²⁶Global Witness. “Heavy Mittal? A State with a State: The Inequitable Mineral Development Agreement between the Government of Liberia and Mittal Steel Holdings NV” (2006). Global Witness. “Update on the Renegotiation of the Mineral Development Agreement between Mittal Steel and the Government of Liberia,” (August 2007). “Liberian legislature passes the Liberian Extractive Industry Transparency Initiative Act,” Publish What You Pay.org, (last visited June 11, 2009).

²⁷“Taxation of the Mineral Section,” Chapter 2 in James Otto, Craig Andrews, Fred Cawood, Michael Doggett, Pietro Guj, Frank Stermole, John Stermole, and John Tilton, *Mining Royalties. A Global Study of Their Impact on Investors, Government, and Civil Society* (Washington, DC: The World Bank, 2006).

²⁸International Council on Mining & Metals (ICMM), *The Challenge of Mineral Wealth: Using Resource Endowments to Foster Sustainable Development. Chile: Country Case Study*, (2007).

or more years before receiving any tax revenue, so a mix of a (low) royalty and an income tax (even an excess profits income tax) is perhaps the most favorable outcome.

Third, recent experience shows that there is a need for eyes-wide-open caution about earmarking a share of extractive industry payments to be given to local communities. The history of some countries, like Nigeria, shows that local communities where natural resource investments lie are often left with very little to show from whatever revenues are captured from those investments. But contemporary evidence from the allocation of revenues directly to local authorities reveals that the latter have weak planning capability, little experience with tenders and contracts, and a tendency to adopt short-sighted expenditures on *futbol* stadiums and other popular undertakings beset by corruption even more pervasive than at the national level.²⁹ Perhaps a better model can be found in Chile's centralized budget allocations directed to roads and schools in mining regions that has resulted in measurably superior poverty reduction in Antofagasta.³⁰

Within a setting of reasonable transparency and appropriate governance (corporate governance and host governance), a rich natural resource endowment can regain the stature it was assumed to occupy in early development text books, as the base for broad-based and lasting national development.

3. Not All Manufacturing FDI is “Good for Development”.

The evidence from the 1980s and 1990s showed that the model of imposing performance requirements on manufacturing FDI in protected national markets to compel technology transfer and promote import substitution did not work very well, if at all. International companies forced to form joint ventures with local partners held back their cutting edge technology, precisely because they feared “leakage” of production and marketing techniques. Cost/benefit analysis of plants built behind tariff walls shows that they actually subtracted from national welfare and inhibited host country growth. Most importantly, domestic content and joint venture mandates prevented the formation of closely integrated manufacturing supplier networks that analytic insight 5 (below) will show is where the most dynamic contribution to host country development can be found.

The empirical discovery that tighter controls on the operations of manufacturing multinationals hurt host economic prospects -- and fewer controls on manufacturing multinationals enhance the prospects for greater value-added and more competitive

²⁹ Author interviews, Peru, (June 2007). Cf. *Peru Phase III Spotlight Note*. (London: International Council on Mining and Minerals (ICMM), (August 2008).

³⁰ For evidence from Chile and other countries with mining industries, see International Council on Mining & Metals (ICMM) and Commonwealth Secretariat. “Minerals Taxation Regimes: A review of issues and challenges in their design and application,” (London: ICMM and Commonwealth Secretariat, February 2009), Chapter 4, “Collection and distribution of mining taxes at the sub-national level.”

backward linkages -- continues to take many in the *pro-poor sustainable development policy community* by surprise. Enthusiasm for performance requirements led some developing country representatives (backed by NGO advisers) to insist at the Hong Kong WTO Ministerial in 2005 that implementation of the TRIMs Agreement (Trade Related Investment Measures Agreement) – which bans domestic content and trade-balancing mandates – be pushed as far into the future as 2020. Contemporary policy advice from some quarters continues to champion use of these measures on manufacturing multinationals, as shown in the debate about revising the US model Bilateral Investment Treaty (BIT).³¹

But the evidence consistently demonstrates that TRIMs – especially domestic content requirements – inhibit the contribution of manufacturing FDI to long-term sustainable growth.³² The latest UNCTAD research on TRIMs (2007) – examining experiences in Argentina, Pakistan, Philippines, Ethiopia, and Vietnam -- reiterates what earlier studies have shown, namely how counterproductive performance requirements have turned out to be.³³ The supposed exception proves the rule: the growth of the motorcycle parts industry in Vietnam came about because the fundamental economics for Honda, Suzuki, and Yamaha to find local parts suppliers were favorable, not because of the legal requirement to meet a 60 percent domestic content. As for Vietnam’s automotive industry, the evidence casts “doubt on the merit of TRIMs in fostering an indigenous automobile industry”; whereas in Vietnam’s electronics industry, and wood, milk, cane sugar, and vegetable oil processing industries, “the merits of TRIMs may have been overrated.”³⁴

³¹Center for International Environmental Law, EarthJustice, Friends of the Earth US, Oxfam America, and Sierra Club, “Comments on the US Model Bilateral Investment Treaty (BIT),” Document ID USTR-2009-0019-0027.1, (July 31, 2009), <http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480a02066>, (last visited August 7, 2009). Working Group on Development and Environment in the Americas, *Foreign Investment and Sustainable Development: Lessons from the Americas*. (Washington, DC: Heinrich Boll Foundation North America, 2008).

³² Export performance requirements may offer more potential – export performance and trade-balancing requirements did play a catalytic role in encouraging international auto investors to build world-scale sized engine and final assembly plants in Mexico and Thailand in the late 1970s. The requirement to export stimulated international companies *to turn away from* building sub-scale plants to produce for protected national markets to creating world-scale production facilities. Export performance requirements or trade-balancing mandates that simply use trade rents to cross-subsidize a few exports from boutique plants, in contrast, do not lay the foundation for an international competitive industry.

³³ UNCTAD, *Elimination of TRIMs: The Experience of Selected Developing Countries*, UNCTAD Current Studies on FDI and Development No. 5. (2007).

³⁴ *Ibid.*, pp. 133, 141-142.

The *pro-poor sustainable development policy community* – including World Bank and regional development banks, national assistance agencies (Export-Import credit agencies, official Political Risk Insurers, as well as AID agencies), and civil society NGOs – will want to endorse the TRIMs Agreement and drop efforts to change the US Model BIT in this particular area, and discourage host imposition of performance requirements on multinational manufacturing investors. As the concluding section of this chapter points out, such a stance is a far cry from contemporary reality.

4. Applying External Pressure to Help Low-Skilled Workers without Generating Counterproductive Consequences is Difficult but Not Impossible.

As noted earlier, there is abundant evidence that FDI in low-skill intensive manufacturing and assembly in poorer as well as middle-income countries can have important developmental impacts. Paul Romer chose Mauritius when it was one of the world's poorest countries as an example in which low-skill intensive FDI could have a transformative influence on the economy.³⁵ Foreign investors fueled a growth record that ranked Mauritius seventh among the fifteen most successful exporters of manufactured products in the world, reaching more than \$1.2 billion in 2008 (51 percent of all exports), with 413 companies employing 65,000 workers. The Dominican Republic had a per capita GDP only two-thirds as high as Mauritius when the government started to lure FDI into manufacturing and assembly. By 2008, total zone investment exceeded \$1 billion, total zone employment was 155,000, and total zone exports reached \$4.5 billion (65% of all exports). In Kenya, 10-15 percent of all formal employment consists of smallhold farmers becoming "indirect exporters" of fresh vegetables and flowers via multinational corporate networks (50-60,000 employed directly and some 500,000 in associated activities related to cut flowers alone in 2008).³⁶ Production of garments, footwear, toys and other such products for export can provide a channel out of rural areas, and out of the informal economy, for hundreds of thousands of workers. In Bangladesh, foreign investors and indigenous subcontractors lobbied against Muslim traditions prohibiting women from working in factories. Today, two million workers, predominantly female, are employed in Bangladesh's garment export sector, earning 25 percent more than the country's average monthly per capita income.³⁷

³⁵ Paul Romer, "Two Strategies for Economic Development: Using Ideas and Producing Ideas," *Proceedings of the World Bank Annual Conference on Development Economics*, (Washington, DC: World Bank, 1992).

³⁶ Jane Ngige, Kenya Flower Council. August 5, 2009. "Roses from Kenya Bloom," Management Talk Q&A, <http://www.123jump.com>, (last visited on September 23, 2009). David E. Bell, Brian Milder, Mary Shelman, *Vegpro Group; Growing in Harmony*, (Harvard Business School Case 9-508-001, December, 2007).

³⁷ *The Role of Labor-Related Issues in the Foreign Assistance Framework: Bangladesh Labor Assessment* (Washington, DC: USAID, draft, November 2008).

To combat sweatshop abuses in Export Processing Zones and Free Trade Zones is a notoriously complicated undertaking. The most successful “campaigns” frequently involve multiple international and local participants, including labor unions, NGOs, and independent auditors and monitors. The struggle to unionize Haynes TOS Dominicana plant, for example -- which produces fabric for T-shirts and is one of the largest textile manufacturers in the Dominican Republic’s export industry -- lasted from 2006 to 2008. The Workers Rights Consortium (WRC), an independent labor right monitoring organization founded by university administrators, labor experts, and student activists launched an investigation of worker complaints in October 2006.³⁸ WRC has more than 150 college and university affiliates concerned about garments bearing their collegiate logos. The AFL-CIO’s Solidarity Center provided technical and legal support during the unionization drive. After Haynes became a member of the Fair Labor Association (FLA), an NGO with socially responsible companies, universities, and civil society organizations on its Board, the FLA received a complaint (February 2008) about noncompliance with the FLA Code of Conduct in the area of freedom of association and collective bargaining and initiated consultations among all the stakeholders.³⁹ At the end of tough but successful bargaining, Haynes and the Sindicato de Trabajadores TOS Dominicana signed their first collective agreement on August 12, 2008.⁴⁰

In a slightly different application of external pressures, the campaign to help workers at the Legumex fruit and vegetable processing plant in Guatemala was launched by the National Labor Committee (NLC), an NGO formed to combat sweatshop abuses with backing from organized labor.⁴¹ The NLC worked through a local NGO, the Center for Education and Support for Local Development (CEADEL), to ensure all workers earned at least the minimum wage, were paid for overtime, were inscribed in the Guatemalan Social Security Institute, had protective gear to wear in the cutting areas, and enjoyed new bathrooms and a cafeteria with tables and chairs. On March 18, 2007, the NLC, CEADEL, the US buyer, and the plant management signed an agreement confirming these “major improvements”, as characterized by the NLC.⁴²

It is by no means certain, of course, that even highly coordinated intensive campaigns will be successful. Beginning in 2008 the Russell Corporation, privately-held within the

³⁸ The WRC Report is available at:

http://www.workersrights.org/Freports/TOSDominicana_Report_06-06-07.pdf.

³⁹ Third Party Complaint Regarding TOS *Dominicana*, Dominican Republic, August 20, 2008 at: <http://www.fairlabor.org>.

⁴⁰ AFL-CIO American Center for International Labor Solidarity, “Dominican Garment Workers Sign First Contract,” (August 12, 2008), <http://www.solidaritycenter.org>.

⁴¹ Harvest of Shame at <http://www.nlcnet.org>.

⁴² Harvest of Shame Update: Major Improvements at Legumex in Guatemala, <http://www.nlcnet.org>.

Berkshire Hathaway investment group, faced pressures across a broad front because of complaints about labor practices at its Jerzees de Honduras plant. The Workers Right Consortium asserted that Russell managers had carried out a campaign of retaliation and intimidation against members of the company union Sitrajerseesh, which led to closure of the plant in January 2009.⁴³ WRC insisted upon re-opening of the plant and reinstatement of the workers. Major universities – including Duke, University of Wisconsin, University of Michigan, and Georgetown University – launched a boycott of Russell. In May, sixty-five US Congress members wrote to the Russell senior management expressing concern about labor practices. In June, Russell was placed on probation by the Fair Labor Association – first in FLA history -- for failure to follow through on a remediation plan for the workers.⁴⁴

In the context of campaigns such as these, it is odd – but not unusual – to discover international trade union representatives claiming that they should be the exclusive advocates for the interests of developing country workers, and denying any standing to NGOs and other civil society labor rights organizations.⁴⁵ It is undeniable that local unions might be able to have closest continual contact with the plight of workers, and avoid the disadvantages that external attempts to spot check conditions under possibly faked conditions encounter. But the depiction of independent democratically-run trade unions aiming solely to represent the best interests of their membership – as idealized in textbooks about the role of trade unions in developed countries⁴⁶ – often differs significantly from the politically-connected, extortion-focused, corrupt organizations found on the ground.⁴⁷

⁴³ Workers Rights Consortium, “Russell Corporation’s Rights Violations Threaten 1800 jobs in Honduras,” <http://www.workersrights.org>, (last visited August 6, 2009). International Trade Union Confederation, (ITUC), “Annual Survey of Violations of Trade Union Rights in the Americas,” <http://www.solidaritycenter.org>, (last visited August 6, 2009).

⁴⁴ Fair Labor Association, “The FLA Board today issued a new resolution regarding Russell Corporation,” <http://www.fairlabor.org>, (last visited on August 6, 2009).

⁴⁵ Comments of Ellie Larson, Executive Director, Solidarity Center, and Mark Hankin, Senior Assistant for Program Development, Solidarity Center, at *Labor Forum; The Role of the Labor Sector in Promoting US Foreign Assistance Goals: Lessons Learned to Date*, (Washington, DC: USAID, June 30, 2009). Presentation of Dwight Justice. “Assessing Freedom of Association,” National Academies of Science, *Quality of Information: Summary of a Workshop* (Washington, DC: National Research Council of the National Academies, 2003), pp. 27-29.

⁴⁶ George J. Borjas. *Labor Economics*, Fourth edition (Boston: McGraw-Hill 2007). James T. Bennett and B. Ed. Kaugman, eds., *What Do Unions Do? A Twenty-Year Perspective*. (New Brunswick: Transaction Publishers, 2007).

⁴⁷ *The Role of Labor-Related Issues in the Foreign Assistance Framework: Bangladesh Labor Assessment*, 2008, *op. cit.* *The Role of the Labor Sector in the Foreign Assistance*

A somewhat unexpected ally in the struggle for better treatment of workers may be found within the ranks of higher-skill multinational investors. International companies producing more sophisticated goods and services – long accustomed to following more progressive human resource policies themselves -- have sometimes played a central role in reducing conflict and extending the recognition of core labor standards to Export Processing Zones and Free Trade Zones. In the Dominican Republic, Philippines, and Costa Rica household names from the US and European business communities helped broker the passage of ILO-consistent labor laws that extended nationwide, and pushed for more effective enforcement of the resulting regulations on the local level, including communal disciplining of violators, in the self-interested search for “labor peace”.⁴⁸ Intel and Siemens are simply not willing to tolerate the strife and reputational threat posed by labor abuse in low-skill plants next door. When host countries are successful in attracting middle-skill foreign investors to build plants alongside low-skill foreign investors (see analytic insight 5, next), there may be “labor institution externalities” that accompany this upgrading of the mix of investors.

With regard to appropriate wage levels, foreign investors in low-skill intensive manufacturing and assembly – like other foreign investors -- almost universally offer higher levels of wages and benefits than comparable local firms. In Madagascar, for example, Mireille Razafindrakoto and Francois Roubaud found that foreign investors in export processing zones paid 15-20 percent more than what workers with similar qualifications received elsewhere in the economy, after holding education level, extent of professional experience, and length of tenure in the enterprise constant.⁴⁹ The evidence from Latin America and Africa shows a similar wage-premium, including in low-skilled operations.⁵⁰ Robert Lipsey goes so far as to enunciate a “universal rule” that foreign-owned firms and plants pay higher wages than domestically owned ones.⁵¹

Framework: Honduras Labor Assessment. (Washington, DC: USAID, draft, January 2009). Heba F. El-Shazli, Regional Program Director, Middle East, Solidarity Center, comments on the official labor federations in Egypt and Algeria. (Washington, DC: Labor Forum; The Role of the Labor Sector in Promoting US Foreign Assistance Goals: Lessons Learned to Date, June 30, 2009).

⁴⁸Moran, *Beyond Sweatshops: Foreign Direct Investment and Globalization in Developing Nations*, *op. cit.*, US Secretary of State’s Award for Corporate Excellence 2009. Background materials on Intel, US Embassy San Jose, (June, 2009).

⁴⁹Mireille Razafindrakoto and Francois Roubaud, “*Les Entreprises Franches a Madagascar: Economie d’enclave ou promesse d’une nouvelle prosperite? Nouvel esclavage ou opportunité pour le developpement du Pays?*,” *Economie de Madagascar*, No. 2., (1995).

⁵⁰Brian Aitken, Ann Harrison, and Robert E. Lipsey. “Wages and Foreign Ownership: A Comparative Study of Mexico, Venezuela, and the United States,” *Journal of International Economics* 40(3-4) (1996). pp. 345-71; Dirk Willem te Velde and Oliver

Edward “Monty” Graham double-checked to see whether such wage-premiums might be more pronounced in richer developing countries, and less evident in poorer developing countries, and discovered exactly the opposite: compensation per indigenous employee in foreign plants in the manufacturing sector is larger, as a multiple of average compensation per employee in the local manufacturing sector, in poorer countries than the middle-income developing countries.⁵² In the latter, the ratio of foreign-paid wages to indigenous-firm wages in manufacturing is 1.8; in low-income developing countries, the ratio of foreign-paid wages to indigenous-firm wages in manufacturing is 2.0, or twice as high as average compensation in the local manufacturing sector.⁵³

But actual wage levels may nonetheless be dismayingly low, causing justifiable consternation on the part of external observers. What might be done about this? Trying to find an answer poses genuine quandaries for the pro-poor sustainable development community.

My own reading of the evidence is quite pessimistic about how to design policies to intervene in markets directly to advance the interests of workers through higher wages, without having counterproductive effects.⁵⁴ High minimum wages and living wages not tied to relative productivity tend to make exporters uncompetitive. Living wages calculated to support worker families of regional average size discriminate against younger, older, and single workers (this outcome is unaddressed, and simply ignored, by many pro-labor organizations.)⁵⁵ High minimum wages act as a disincentive for hiring of

Morrissey., “Do Workers in Africa Get a Wage Premium if Employed in Firms Owned by Foreigners?,” *Journal of African Economies*, Volume 12, Number 1 (2003), pp. 41-73.

⁵¹Lipse, Robert. “Measuring the Impacts of FDI in Central and Eastern Europe,” (Cambridge, MA: National Bureau of Economic Research. Working paper 12808. 2006). Alexander Hijzen, “Do Multinationals Promote Better Pay and Working Conditions?,” (*OECD Observer* No 269. Organisation for Economic Co-operation and Development (OECD): October, 2008).

⁵²Edward M. Graham, *Fighting the Wrong Enemy: Antiglobal Activists and Multinational Enterprises* (Washington, DC: The Institute for International Economics, 2000), Table 4-2, pp. 93-94.

⁵³Graham removes salaries for foreign managers and supervisors from these calculations.

⁵⁴For more analytics, see Moran, *Beyond Sweatshops: Foreign Direct Investment and Globalization in Developing Nations*, *op cit*.

⁵⁵International Labor Organization. *Declaration on Social Justice for a Fair Globalization*. Geneva: ILO, June 2008. Organization for Economic Co-operation and Development (OECD) Watch. *Key issues for a review of the OECD Guidelines*. December 2009. <http://www.oecdwatch.org>.

entry-level and other lesser-skilled workers. The most effective public policy to augment the earnings of low-skilled workers – besides skill-training to improve their productivity – is an earned income tax credit or other form of negative income tax, which is quite expensive for any government to implement.

One idea that may hold promise is the following: pressure from CSR and NGO groups on international companies that produce or sell highly-branded or collegiate-logo products to ensure that lowest level workers receive what might be called a “decent wage”, say prevailing wage per skill level plus a premium of 20 per cent. But any such decent-wage system must be designed to transfer oligopoly rents from the international marketer or retailer (or from consumers) to the workers; it cannot simply insist that production companies and their subcontractors pay above-market wages and absorb the costs themselves. A direct transfer mechanism from consumers, or from branded oligopolists, to production-line workers is a feature of many “fair trade” arrangements: in the Kenya flower industry, companies that want to qualify for the Fair Trade label promise to assign eight percent of the free-on-board price for flowers to education and health initiatives as determined by worker-management committees.⁵⁶ Wages and benefits for each worker depend upon experience and performance, but – in the case of one of the largest international flower and fresh vegetable exporters, Vegpro of Canada – is 15-20 percent above the sector minimum wage for entry level workers and 30-40 percent higher for more experienced workers.⁵⁷

5. Using FDI to Diversify Production (and Exports) and Move from Lower-Skilled to Higher-Skilled FDI Operations is the New Frontier for Development Policy.

Although popular preoccupation about globalization and worker issues in the developing world focuses on low-wage sweatshop-type concerns, the data show clearly that by far the majority of manufacturing FDI in developing countries flows to more advanced industrial sectors rather than to garment, footwear, and other lowest-skilled operations, and the weighting toward more skill-intensive investor operations is speeding up over time.

As Table 1 demonstrates, the flow of manufacturing FDI to medium-skilled activities such as transportation equipment, chemicals, rubber, plastic products, industrial machinery, electronics and electrical assemblies is nearly ten times greater each year than the flow to low-skilled, labor-intensive operations, and has been speeding up over time. The ratio between higher and lower skill-intensive activities was approximately five times larger in the period 1989-1991, but almost ten times larger in the period 2004-2006.

⁵⁶ Bell, Milder, and Shelman, *Vegpro Group; Growing in Harmony*, Harvard Business School Case 9-508-001, *op. cit.*

⁵⁷*Ibid.*, p. 12.

If the stock of manufacturing FDI is substituted for the flow, similar results hold true: a ratio of seven to one in 1990, a ratio of ten to one in 2006 (these ratios are probably understated, moreover, since data on FDI stocks typically do not provide accurate information on reinvested earnings and allowances for accelerated depreciation which are concentrated in the more capital-intensive higher-skilled FDI operations).

Table 1
Manufacturing MNC Operations in Developing Countries

	FDI Flows (millions of dollars)			FDI Stocks (millions of dollars)		
	1989-1991 (annual average)	1999-2000 (annual average)	2004-2006 (annual average)	1990	1999	2006
Lowest-Skilled Sectors	\$2,860	\$3,100	\$9,526	\$19,885	\$46,864	\$65,134
Higher-Skilled Sectors	\$13,270	\$52,800	\$92,818	\$134,686	\$505,928	\$653,277

For a complete breakdown by sector, see Annex I (FDI flows) and Annex II (FDI stocks) from the UNCTAD data base in my forthcoming book, Moran, *Foreign Direct Investment and Development: Launching a Second Generation of Policy Research, Avoiding the Mistakes of the First*, (Washington, DC: Peterson Institute of International Economics, forthcoming 2010).

How great are the benefits that come from the liberalization of trade and investment as host countries move up the latter from low-skilled to higher-skilled FDI activities?

The standard models that dominate economic calculations today far underestimate the potential benefits from the continuous opening of developing countries to trade-and-FDI simultaneously. This is because such models implicitly assume that all the goods and services that can be produced in a given economy are already “known”, and the gains from trade-and-FDI liberalization come simply from letting firms and workers do what they are already capable of doing more efficiently.⁵⁸

⁵⁸Paul Romer, “New Goods, Old Theory, and the Welfare Costs of Trade Restrictions,” *Journal of Development Economics* 43, (1994). I am grateful for help on contemporary modeling of trade and investment impacts from William Cline and Kamal Saggi.

But this assumption is obviously inaccurate, argue Ricardo Hausmann and Dani Rodrik.⁵⁹ Dynamic comparative advantage means that entrepreneurs do not already “know” all the production possibilities within a given economy. The key to development is to identify new and more sophisticated activities, and bring them into being. Here foreign investment can play a key role, carrying a host economy with one leap to the cutting edge of technology and management in some novel industry. When Texas Instruments brings advanced electronics for the first time into the Philippines, or Volkswagen brings high performance auto parts for the first time into Slovakia, or Seagate brings disk drive manufacture for the first time into Malaysia, four hitherto underappreciated accomplishments are being realized simultaneously. Texas Instruments, Volkswagen, and Seagate are helping the host country to move up the ladder from low-skilled activities to higher-skilled activities; they are helping to diversify exports; they are placing the host along the frontier of best practices in the international industry; and they are hooking the host into every improvement and advance that takes place in the industry anywhere on a near real-time basis. The resulting benefits from foreign investment are on the order of **ten to twenty times greater** than what models estimate when the host simply does more of what it already does more efficiently.⁶⁰

But using FDI to help transform the production and export base of a country does not come about easily. As Hausmann and Rodrik point out, there are important market failures that inhibit this process from taking place naturally when hosts simply lower barriers to trade and FDI. These market failures include coordination externalities (hosts must ensure reliable infrastructure and access to specific-skilled healthy workers and technicians), information asymmetries (hosts must prepare customized proposals for first-time investors), and appropriation problems (risk averse multinationals often prefer to do follow-the-leader rather than first-mover investment). There are environmental standards that have to be set, and enforced, to cover electronics and auto parts plants, no less than mines and refineries.

To overcome these market failures – and allow the host to upgrade and diversify its economic activities and export base – requires up-front expenditures and sustained effort, in addition to the liberalization of trade-and-investment. It has become increasingly clear that paying international consultants to conduct yet one more policy-review in drive-by fashion, handing the results over to host authorities with an impressive-looking cover has very marginal utility. What is needed is support from the *pro-poor sustainable development policy community* to sustain genuinely effective Investment Promotion Agencies, prepare customized FDI proposals for potential investors, create public-private programs for healthcare and vocational training, provide on-call assistance for infrastructure, and identify and motivate indigenous program-and-policy champions.

⁵⁹Ricardo Hausmann and Dani Rodrik. “Economic Development as Self-Discovery,” *Journal of Development Economics*. 72 (2003), pp. 603-633. Ricardo Hausmann, Jason Hwang, and Dani Rodrik. “What You Export Matters,” *Journal of Economic Growth*. 2009. .

⁶⁰Romer, “New Goods, Old Theory, and the Welfare Costs of Trade Restrictions,” *op. cit.*

This is the new frontier where multilateral banks (World Bank group and regional development banks), national assistance agencies, and international civil society can cooperate to underwrite entirely new economic activities, while creating cutting-edge industrial zones and science parks. As the concluding section points out, the performance of one vital segment of this grouping – national assistance agencies – is spotty in the extreme and sometimes explicitly forbidden.

Such an endeavor is all the more valuable when undertaken in conjunction with host country efforts to deepen backward linkages from foreign investors to local firms and develop indigenous supplier networks, considered next.

6. Enlarging Backward Linkages from FDI, and Expanding Local Supply-Chains is the Biggest Contemporary Challenge.

Development strategists dismayed by how counterproductive are the results from imposing performance on multinational corporations can take comfort in the refreshing discovery of spillovers and externalities from multinationals that are not burdened with domestic content and joint venture mandates.

To be sure, “technology transfer” in a horizontal direction from multinational corporations is somewhat of an oxymoron. Manufacturing MNCs try assiduously to prevent the leakage of technology, production techniques, and trained personnel to other firms that might become rivals. Luckily – from a developmental point of view – they are not always successful, as workers and managers carry on-the-job experience around the industry. Contemporary survey data from Eastern Europe highlight two additional channels through which local firms watch and copy foreign practices: one quarter of the managers of Czech firms and fifteen percent of the managers indicated that they came to understand new technologies by observing foreign firms enter their industry; twelve percent of the Czech managers and nine percent of the Latvian managers discovered new marketing techniques and sales outlets by watching the foreigners’ operations.⁶¹

In the vertical direction, the dynamics of technology transfer are far different. Manufacturing MNCs find it in their self-interest to identify and nurture local suppliers. The survey data from Eastern Europe record multiple forms of direct assistance between foreign investors and new suppliers: assistance with setting up production lines, help with management strategy and financial planning, advance payment and others kinds of financing, coaching in quality control, and introduction to export markets (an export

⁶¹Beata Smarzynska Javorcik and Mariana Spatareanu, “Disentangling FDI Spillover Effects: What Do Firm Perceptions Tell Us?,” In Theodore H. Moran, Edward M. Graham, and Magnus Blomström, eds., *Does Foreign Direct Investment Promote Development?* (Washington, DC: Institute for International Economics, Center for Global Economics. 2005).

externality).⁶² In Indonesia, Garrick Blalock and Paul Gertler find that foreign multinationals not only helped indigenous firms with production techniques, quality control, and management but likewise introduced successful Indonesian suppliers to sister affiliates of the multinationals around Southeast Asia.⁶³

The development of a local supplier base does not happen quickly or automatically. Time is required for MNCs to develop backward linkages. Axele Giroud and Hafiz Mirza find that the extent of local input linkages in Malaysia, Thailand, Vietnam, and Cambodia vary directly as a function of how long the local foreign affiliate has been in the country.⁶⁴ Rene Belderbos, Giovanni Capanelli, and Kyoji Fukao find that the same for Japanese multinationals.⁶⁵ Local firms also need business-friendly local conditions, skilled workers – and access to imported intermediates – in order to prosper, and sharpen their skills. If the gap in sophistication between foreign investors and indigenous companies is too large, few linkages result. In Mexico, Ari Kokko found that spillovers between foreign affiliates and local firms varies as a function of the productivity difference between the two.⁶⁶ In the Uruguayan manufacturing sector, Ari Kokko, Ruben Tansini, and Mario Zejan observe the same phenomenon.⁶⁷

⁶²Javorcik and Spatareanu, “Disentangling FDI Spillover Effects: What Do Firm Perceptions Tell Us?,” in Moran *et al*, *Does Foreign Direct Investment Promote Development?* *op cit*.

⁶³Garrick Blalock and Paul J. Gertler, “Welfare gains from foreign direct investment through technology transfer to local suppliers,” *Journal of International Economics* 74(2) (March 2009), pp. 402-421.

⁶⁴Axele Grioud and Hafiz Mirza, “Factors determining supply linkages between transnational corporations and local suppliers in ASEAN,” *Transnational Corporations* 15 (3), (December, 2006).

⁶⁵Rene Belderbos, Giovanni Capanelli, and Kyoji Fukao, “The Local Content of Japanese Electronics Manufacturing Operations in Asia,” In Takatoshi Ito and Anne O. Krueger, eds., *The Role of Foreign Direct Investment in East Asian Economic Development* (Chicago: University of Chicago Press for the National Bureau of Economic Research, 2000).

⁶⁶Ari Kokko, “Technology, Market Characteristics, and Spillovers,” *Journal of Development Economics* 43, no. 4 (April 1994), pp. 279-93. The importance of the skill-difference between foreign investors and potential suppliers is different from the argument that FDI cannot raise the productivity of a host economy until a threshold human resource level has been achieved.

⁶⁷Ari Kokko, Ruben Tansini and Mario C. Lejan. “Local Technological Capability and Productivity Spillovers from FDI in the Uruguayan Manufacturing Sector,” *Journal of Development Studies* 32 (April, 1996), pp. 602-11.

To spur the process along some countries have instituted vendor development programs.⁶⁸ Singapore paid a part of the salary of FDI managers who would act as talent scouts among local enterprises, and provided loans to indigenous companies for equipment recommended by foreign buyers. Malaysia and Thailand have set up industrial parks alongside their country's large EPZs, with registries of local firms in those parks. Even in cases of success, the spread of supplier networks always appears "too slow" and "too limited": El Salvador aspires to the backward linkages of the Dominican Republic; the Dominican Republic aspires to the backward linkages of Costa Rica; Costa Rica aspires to the backward linkages of Ireland; Ireland aspires to the backward linkages of Germany. Nonetheless, the logical conclusion for the *pro-poor sustainable development policy community* – after supporting infrastructure development, public-private partnerships in vocational skill-building institutions, and on-the-job and night training classes (analytic insight 5 above) – is to support a business-friendly local economic environment, backed by an increasingly open trade regime, in order to promote backward linkages and supplier networks.

7. The Effort to Cap and Roll-Back Tax Breaks and other Giveaways to Multinational Investors must be an International Initiative.

The preceding two analytic insights have recommended that multilateral and national donors, backed by international civil society, provide support to help would-be hosts to improve infrastructure, vocational training, and investment promotion to attract more sophisticated foreign investors to first-class economic zones and industrial parks, and expand local supplier networks. To the extent possible, the not-inconsequential financial expenditures associated with these endeavors should be separated from the mindless competition in tax breaks and giveaways that now besets the scramble for investment around the world.

There is now solid econometric analysis to demonstrate that there is a growing competition among developing country FDI sites, and between developing country FDI sites and developed country FDI sites, to secure international investment. John Mutti finds that the independent influence of taxes on the location of production is statistically significant and growing over time, and that the impact of tax competition is particularly intense among locales where much of the output is destined for export.⁶⁹ Case study

⁶⁸ United Nations Conference on Trade and Development, (UNCTAD), *World Investment Report 2001: Promoting Linkages*, Box V.4. (2001), pp 176-177.

⁶⁹ John Mutti, *Taxation and Foreign Direct Investment* (Washington, DC: Peterson Institute of International Economics, 2003). For recent cases in both developed and developing world, see Kenneth Thomas, *The Political Economy of Investment Incentives: Competition for Investment on a Global Scale*. (Palgrave, Forthcoming 2010).

evidence reveals that international corporations typically identify three or four roughly comparable investment sites, and then unleash their negotiators to bring back the biggest tax breaks as a “tiebreaker”.

This competition in tax breaks has all the pernicious characteristics of the prisoner’s dilemma. No participant can refuse to give in to the demand for tax breaks on his own without losing out entirely. What is needed is an international cooperative endeavor to limit and then roll-back such self-destructive behavior. The challenge for achieving progress in such an undertaking is that states – and even municipalities – must be brought under common control, Sao Paulo no less than Alabama, Brno no less than the “Eastern Corridor” of Malaysia.

B. Implications for the Pro-Poor Sustainable Development Community

Foreign direct investment – in all its forms – is at best only a modest force in raising living standards and enhancing economic and social welfare around the world. But the evidence introduced here shows that the positive benefits from main-line FDI activities can be much larger than customarily portrayed. These positive benefits cannot be assumed to arrive – and negative damages avoided – simply by allowing market forces to operate on their own. Instead an array of outside interventions, outside pressures, outside support mechanisms are needed to optimize the contributions that FDI can make to development.

This chapter has tried to identify what the most important of these outside interventions, outside pressures, outside support mechanisms are, and to argue that these should become a principal focus for the pro-poor sustainable development community, including multilateral lenders, national assistance agencies (including Export-Import Banks and Political Risk Insurers, as well as aid agencies), international labor and civil society groups, and corporate social responsibility advocates.

1. World Bank Group and Other Multilateral Financial Institutions

As the financial crisis fades, the World Bank Group and other multilateral financial institutions will once again face the perennial question of whether they still should devote their scarce resources to middle-income countries, especially in the midst of a revival of strong FDI flows. The evidence introduced here demonstrates that the list of market misfunctions indeed extends to middle-income developing countries, especially extractive industry-rich developing countries, and manufacturing-base developing countries struggling to upgrade and diversify their exports.

But the World Bank Group and regional development banks should reshape their approach to helping integrate foreign investment into development strategy. With regard to natural resource FDI, the EITI ++ agenda is well on-track, although the initiative must be transformed into concrete work plans with monitored results, and shaped to extend the

umbrella of transparency and non-corruption to investors from all countries. The most significant expansion of the EITI ++ approach, as recommended here, involves additional help for developing country authorities in negotiating oil and mining investment agreements.

With regard to FDI in manufacturing and assembly, much work still needs to be done on the nuts and bolts of investment promotion among low-income countries. Survey data show that many low-income country Investment Promotion Agencies fail even to answer telephone calls and emails from prospective investors.⁷⁰ A majority of those that do are nonetheless unable to provide information or advice to an investor beyond what already appears on the IPA website. IPA websites themselves often have incorrect or incomplete telephone numbers and email addresses. But other IPAs are able to show dramatic improvement – Ghana, Botswana, Honduras, Sri Lanka, and Romania, among them in 2008.⁷¹

Turning to the challenge of helping developing countries move up the ladder from lowest-skilled operations to more sophisticated FDI activities, the day of simply handing over consultant reports on policy reform, perhaps supplementing the reports with training seminars on investment attraction, must give way to coherent action plans to attract higher skilled investors and expand the domestic supplier base. The ingredients include customized investment promotion, backed by resources for FDI-associated infrastructure and vocational training, with sustained on-the-ground technical support, carefully linked into local policy champions and advocates.

Finally, World Bank Group and regional development banks must screen out support for FDI projects that rely upon trade protection to survive, as considered in more detail next.

2. National Assistance Agencies (including aid, Export-Import Banks, and Political Risk Insurance Agencies)

Like the multilateral financial institutions, national assistance agencies can play an integral role in enhancing the contribution of multinational investment to broad-based sustainable development. In some areas, current approaches must be sustained, such as – in the case of the United States -- USAID's support for Solidarity Center programs to promote labor rights (including labor rights for FDI workers), the Millennium Challenge Corporation's grants for major infrastructure improvements, or OPIC's provision of political risk coverage for FDI in poorest and most difficult developing economies.

Some developed countries have played a catalytic role in helping developing countries to integrate FDI into their development strategy. Germany took an equity stake in the Lesotho National Development Corporation, a central player in the country's dynamic FDI-led export drive, for example, to help get it launched. The US record here is much

⁷⁰*Global Investment Promotion Benchmarking 2009: Summary Report* (Washington, DC: The World Bank Group Advisory Services, May, 2009), Chapter 3.

⁷¹ *Ibid.*, p. 84.

more spotty. USAID has occasionally played an equally vital role as in helping to renovate Costa Rica's Investment Promotion Agency, but has often backed away from such endeavors. The Millennium Challenge Corporation (MCC) has not defined its responsibilities in this arena, and should be instructed to help threshold countries design compacts around the goal of eliminating bottlenecks and facilitating both international and local private sector investment.

In two important areas, fundamental changes are required.

First, the operating policies of some official support programs must be tightened. Seventeen of the twenty major national political risk guarantee agencies do not screen out FDI projects that require heavy host country protection to survive.⁷² The official political risk insurers of the United Kingdom, Canada, Japan, Germany, France, and Italy, for example, assess the likely profitability of FDI applicants but not whether their contribution to host economic welfare is positive. Since protected plants are often highly profitable, they pass the test for insurance support. OPIC has gone so far as to provide political risk insurance against removal of protection, and paid the claim for "breach of contract" when the host country was audacious enough to undertake domestic reform!⁷³

Second – at the same time – other official support programs must be loosened. Seventeen of twenty official political risk insurance agencies in the developed world do provide coverage for projects with the most powerful development impact, including low-skill labor-intensive FDI exports in least developed countries, and middle-skilled FDI exports from more advanced developing countries.⁷⁴ Two countries (Austria and the United States) have self-imposed restrictions that prevent them from providing coverage to foreign investment projects that might in any way compete with home country firms.

Once again US OPIC is the poster child, with a negative image. Originally launched with an explicit "development mission", OPIC has actually been placed under increasingly heavy Congressional restrictions over the past several decades. OPIC is prohibited from providing political risk insurance or financial guarantees to many labor-intensive projects: OPIC is precluded from supporting textile or garment projects, or agricultural processing projects if the crops involved are "in surplus" in the United States. Concern about "sensitive sectors" in the US economy has kept OPIC from offering insurance to US investors interested in setting up Export Processing Zones anywhere abroad. OPIC refuses to support all outward investment projects if there might be *any single job lost* even if *net job creation* within the United States clearly is positive.

3. International Labor and Civil Society Groups

⁷²Center for Global Development, *Commitment to Development Index*. Fall 2009.

⁷³ Robert C. O'Sullivan, "Learning from OPIC's Experience with Claims and Arbitration," In Theodore H. Moran and Gerald West eds., *International Political Risk Management: Looking to the Future* (Washington, DC: The World Bank, 2005).

⁷⁴Center for Global Development, *Commitment to Development Index*, *op. cit.*

The past has seen a vibrant critique of the participation of self-appointed, non-representative NGOs in the affairs of international investors. But the evidence summarized here shows that Transparency International, Global Witness, Publish What Your Pay, Revenue Watch Institute and other international civil society groups – and their local counterparts – have a vital role to play in providing public goods and helping with setting and monitoring international standards. This role is already well established in the activities associated with supporting the Extractive Industry Transparency Initiative and related anti-corruption efforts, but the preceding analysis shows that the need for external pressures covers vital aspects of the operations of manufacturing MNCs as well.

In order to help enhance the contribution of FDI to broad-based sustainable social and economic development, many participants in the pro-poor sustainable development community will have to reexamine some of basic tenets of their past recommendations.

Popular insistence on higher minimum wages or generous living wages for workers is likely to be counterproductive for reasons outlined earlier (leaving plants uncompetitive, or, even if not, discriminating against younger, older, and single workers). Foreign investors and their subcontractors will need some flexibility to alter the level of employment in response to fluctuations in external markets. The challenge is to combine productivity-based wages, labor market flexibility, and broadly-acceptable conditions of work for low-skilled workers. As a special case, low-skilled employees working for suppliers to highly-branded retailers (including collegiate retailers) should be able to garner premium earnings, transmitted to them from oligopoly profits and consumer pockets.

In order to upgrade the production base and diversity exports, international labor and civil society groups will want to acquaint themselves with the negative consequences of imposing performance requirements (joint venture and domestic content requirements) on multinationals – as documented here -- leading them to abandon antagonism toward the TRIMS agreement and pare back their opposition to control of performance requirements in the US Model BIT.⁷⁵

Topping this off, international labor and civil society groups will want to recognize the importance of business-friendly treatment of local firms as an essential ingredient in indigenous supply-chain development.

As participants in “campaigns” to combat denial of worker rights and abusive treatment of labor, international labor and civil society groups have overlapping and mutually supportive parts to play. The attempt by any one group to monopolize the support for international workers and disparage the efforts of others undermines the strength of those who want to help workers in the developing world.

⁷⁵ Center for Environmental Law, EarthJustice, Friends of the Earth US, Oxfam America, and Sierra Club, “Comments on the US Model Bilateral Investment Treaty (BIT),” (July 31, 2009).

4. Corporate Social Responsibility Advocates

It is widely recognized that the concept of corporate social responsibility is very broad and means different things to different constituencies.⁷⁶ With regard to socially responsible multinational corporate investment, the umbrella principles for companies are embodied in the ten fundamental standards in the UN Global Compact:

Human Rights

- Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and
- Principle 2: make sure that they are not complicit in human rights abuses.

Labour Standards

- Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
- Principle 4: the elimination of all forms of forced and compulsory labour;
- Principle 5: the effective abolition of child labour; and
- Principle 6: the elimination of discrimination in respect of employment and occupation.

Environment

- Principle 7: Businesses should support a precautionary approach to environmental challenges;
- Principle 8: undertake initiatives to promote greater environmental responsibility; and
- Principle 9: encourage the development and diffusion of environmentally friendly technologies.

⁷⁶ The Monitor Institute Report, Jessica Freireich and Katherine Fulton, *Investing for Social and Environmental Impact: A Design for Catalyzing an Emerging Industry* (2009) <http://www.monitorinstitute.com/impactinvesting>, identifies Socially Responsible Investing, Social Investing, Mission-Driven Investing, Sustainable and Responsible Investing, Blended Value, Values Based Investing, Mission-Related Investing, Ethical Investing, Responsible Investing, Impact Investing, Program Related Investing, Triple Bottom Line Investing, Environmental, Social, and Governance Investing, pp. 13.

Anti-Corruption

- Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

Besides acknowledging these standards, socially responsible international companies must follow up with internal systems – along with training for employees and managers – to promote compliance, and report results. While reporting systems vary widely, the most widely recognized template is embodied in the Global Reporting Initiative.⁷⁷

But the argument that emerges from the analysis here is that a much more pro-active role from international investors is needed with regard to their main-line operations, well beyond mere “complying” and “reporting”.

To deal with “resource curse” issues, the Global Reporting Initiative indicates, for example, that international investors should “report the percentage of total number of management and non-management employees who have received anti-corruption training”, and “provide a description of significant impacts of activities, products, and services on biodiversity in protected areas and areas of high biodiversity value outside protected areas”).

The recommendation presented in Section II-2 (above) is much more specific and assertive. Socially responsible international resource companies should use their non-inconsiderable influence when they negotiate new contracts or make follow-on investments to bring the countries where their wells and mines are located into the EITI + + regime. Socially responsible international resource investors should join together to create industry-wide standards to preserve the environment, address the needs of indigenous peoples, and incorporate full-life cycle community planning into their projects, while simultaneously supporting capacity- building for local and national monitors. Socially responsible international resource investors – to their own benefit, as argued earlier -- should endorse and push for transparent of revenue streams on an company-by-company basis (thereby exposing non-OECD investors to the same scrutiny as OECD investors), rather than insisting on aggregate-only reporting of revenue stream (which allows non-OECD investors to avoid close scrutiny).

In order to promote backward linkages, the Global Reporting Initiative recommends a report on “how much do you buy locally”. But the analysis presented in Section II-5 (above) identifies much more targeted actions: Has the socially responsible investor designated a manager to be a ‘talent scout’ to search out potential indigenous suppliers (or liaise with local vendor development agencies)? Does the socially responsible investor take measures to provide production advice, managerial advice, and advance purchase orders to potential indigenous suppliers (a teaching externality)? Does the socially responsible investor have procedures to ‘qualify’ and ‘certify’ potential indigenous suppliers (a labeling externality)? And, does the socially responsible investor

⁷⁷ <http://www.globalreporting.org/>

have a program through which qualified indigenous suppliers are introduced to sister affiliates in the region (an export externality)?

With regard to influencing the environment for business, the GRI protocol suggests that international corporations to report on their public policy positions, and their participation in public policy development and lobbying (as recommended in OECD guidelines).⁷⁸ CSR pressure of the kind recommended in Section II-4 (above) would push international corporations to support labor institution externalities, such as ensuring that all members of the business associations they belong to (no matter what skill-level their operations) operate with common and mutually acceptable human resource standards, albeit different wage levels.

One could examine other industry-wide or specific company codes of conduct and – like the long list of reporting protocols in the Global Reporting Initiative -- try to translate the findings reported here about how to optimize the contribution of FDI to development into clear actions on the part of international investors. The common justification for such actions is that the strongest contribution FDI can make to host country growth and welfare comes from well-structured, well-run, environmentally-sound main-line operations of multinational corporations.

At the end of the day, the findings introduced here should not derail the efforts of those in the pro-poor sustainable development group who simply want to pressure international corporations to “give back” more to the communities where they operate – the most frequent outcomes are pressure to set up community-based social projects directly or to provide aid to local organizations and initiatives. But the evidence shows that the principal benefits from foreign investors come from ingredients their main-line operations inject into the host economy directly, not from the accompanying philanthropy (no matter how welcome). The new CSR agenda proposed here insists that direct social or poverty-reduction efforts – even large ones! – should not substitute for an insistence that main-line multinational corporate operations be run in an open, competitive, well-structured manner. Corporate charity surely has its place, but the pro-poor sustainable development policy community will want to begin to refocus on the larger -- and in many ways more important -- set of targets sketched out here.

⁷⁸ Global Reporting Initiative, G3 Guidelines, Indicators Protocol Set: Society available at <http://www.globalreporting.org>.

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