Comment

ROBERT Z. LAWRENCE

How does foreign direct investment (FDI) affect host country development? The three chapters in this section reveal the considerable differences in the way people answer this question. The chapter by Moss, Ramachandran, and Shah chronicles in considerable detail the negative views held by many Africans. It also indicates that despite recent movements toward policy liberalization in East Africa, numerous obstacles to FDI remain. Apparently, FDI is still widely seen as exploitative and risky, bringing few gains to the local community, and these attitudes have affected policies. Moss, Ramachandran, and Shah use survey evidence to show that treatment of foreign firms in East Africa remains discriminatory.

By contrast the chapter by Guoqiang Long describes the effort of the Chinese to attract FDI and their positive experiences and perceptions. By and large, foreign investors have been treated more favorably than private domestic firms, particularly in the initial period of domestic reforms. This preferential treatment actually created incentives for domestic firms to try, through "round ripping," to become foreign firms. Overall, the chapter argues, the FDI experience has been favorable. The Chinese experience seems to have involved a virtuous cycle. Once China succeeded in attracting some foreign firms other countries have sought similar advantages. In attracting foreign firms, has China succeeded in encouraging technological development and diffusion. The chapter paints a positive picture. It presents impressive evidence on how much research and development (R&D) is accomplished by foreign firms in China. It also describes the role

Robert Z. Lawrence, senior fellow, is Albert L. Williams Professor of Trade and Investment at the John F. Kennedy School of Government at Harvard University.

of foreign firms in: demonstrating and introducing new products; making demands by placing orders and providing technical assistance to suppliers; training and research in collaboration with domestic firms and ins-titutions; and providing a manufacturing platform for local firms to participate. While acknowledging the possible dangers of crowding out as well as poaching talented people from local firms and appropriating intellectual property through joint ventures, Guoqiang Long concludes that overall FDI "spillover effects appear more eye-catching than the effects of crowding out."

In his chapter, Ted Moran draws on case studies of many countries to suggest that the different perceptions in these two locations are quite typical of existing FDI literature. Case studies show that FDI has led to impressive performance and results in some countries while it has failed in others.

Why are these perceptions and results so different? Moran's chapter provides one answer: the impact of FDI depends critically on the overall context in which it occurs. If FDI is motivated by the desire to service a protected and distorted domestic market, the effects could well disappoint. Foreign firms may find it profitable to operate, but they may do so without bringing the best technologies and/or using the country as part of their international supply networks. By contrast, impact will likely be positive when FDI is motivated by the desire to participate fully in the international sourcing networks of the parent multinational, and operations are unrestricted by rules on ownership and local content. If the Moran hypothesis is correct, therefore, the divergent perspectives presented in Moss, Ramachandran, and Shah and Guoqiang Long are easily explained: Africa's disappointing experience stems from the fact that its FDI has taken place in distorted and protected markets while China's positive experience results from the fact that it has by and large been directed toward increased global integration.

I find Moran's hypothesis plausible. Its implications for policy and empirical research are important. In fact, Moran's hypothesis about FDI applies to other sources of economic growth such as trade and education. It highlights the importance of the incentives under which such activities occur. For example, if there is one message that comes out very clearly from microeconomic theory, it is that the answer to the question "Is free trade good or bad?" is "It depends." In the face of imperfect markets and the wrong price signals free trade could well make things worse. To be sure it *could* still make things better, but in a second-best world we cannot be sure. If, for example, a country fails to force export industries that pollute to take account of the costs they impose on the environment, more trade has an ambiguous impact on welfare: the social gains from expanding trade and more export production could be more than offset by the social losses from pollution. Likewise, the returns from investing in education could well disappoint if the labor market fails to provide workers with the opportunities to use their knowledge in productive ways. For

example, if you hire many of them for government positions, as was the case in Egypt, or recruit them for Soviet Union firms, the labor market will not see much impact. However, if you hire them for firms in the United States or South Korea, the results could be very different. Failure to control for the impact of such regimes could well lead researchers to draw the wrong conclusions.

However, as the other two chapters reveal, actually implementing Moran's insight is not easy. One issue relates to how we measure contributions to development, and the second issue relates to how we identify liberal and distorted regimes. Consider these issues in turn.

How should the results of FDI be measured? The Moss, Ramachandran, and Shah chapter on Africa, for example, argues that the negative views held by Africans are actually misguided. The authors claim that foreign firms do not crowd out domestic firms in East Africa. Instead, foreign firms favorably affect the economy: foreign firms are bigger, have more skilled managers, and are more likely to have worker training programs. They are likely to export more abroad and invest more locally. Contrary to African perceptions, foreign-owned firms also appear to be fairly well embedded in the domestic economy and to make considerable use of local inputs. Foreign firms also have higher value added per worker that the authors argue, based on econometric evidence, reflects their higher productivity rather than their monopolistic power. Implicitly, therefore, Moss, Ramachandran, and Shah claim that even though African economies remain highly distorted and policies toward foreign investors are discriminatory, FDI already contributes positively to African development. Whereas the Moran hypothesis is that FDI will disappoint in a hostile environment, Moss, Ramachandran, and Shah believe it has succeeded despite the context.

To be sure, one way to reconcile this claim with the Moran hypothesis is to argue that while the net effects of FDI have already been positive in Africa, they would be even more positive in a regime that had fewer distortions. But it is also possible that despite the evidence supplied by Moss, Ramachandran, and Shah, FDI still hurts African welfare given current policies. In particular, even though—as Moss, Ramachandran, and Shah have found—foreign-owned firms are relatively large, train their workers, and have higher value added per worker than domestic firms, their operations could nonetheless reduce host country welfare. For example, Moran quotes a study by Bernard Wasow in which only 3 of 35 products made by foreign-owned firms in Kenya in the 1980s actually created benefits to the national economy in excess of their costs. Hopefully this is no longer the case, but if foreign firms are still misallocating resources because prices are wrong, the country might have been better off if they were smaller and invested less!

This question of how to measure success is present in all three chapters. In particular, evidence that foreign firms use local inputs, use the latest technologies, are larger, invest more, pay higher average wages, export

more, and have higher value added per worker are generally viewed as positive behavior. Moran, for example, lists ways FDI contributes to host country development even when foreign firms do not provide externalities. Contributions to development include whether they add resources, technology, and management as well as whether they introduce new activities, earn foreign exchange, and/or boost competitive substitution of imports in the host country. But these effects are not necessarily linked to increased welfare and well-being.

It might be more or less efficient to behave in these ways. In countries with different factor prices, for example, efficiency might dictate using different technologies and not always the latest. Higher value added per worker could reflect higher markups and the use of more capital rather than more productive technologies. Bigger is not always better. Firms could be too large as well as too small. The central idea here is that association does not imply causation. The fact that most industrial countries produce steel, for example, does not imply that the best way to industrialize is to produce steel. Thus, instead of the broad range of indicators used in the chapters, I would prefer the use of criteria grounded in economic theory.

A second issue relates to how government policy is characterized. Moran has drawn on case study literature to support his hypothesis. It is tempting to suggest that a variable depicting the nature of the government policy be inserted into a more aggregative cross-sectional study of growth just as some studies do with openness. However, problems summarizing the nature of a regime with a single measure occur. Indeed, this issue has long plagued the debate over the "East Asian miracle." According to some views, for example, South Korean success stems from the country's relatively neutral policies. For others, however, the key was that they "got prices wrong" and explicitly promoted exports. Similarly, Guoqiang Long's chapter reveals that China's policies toward foreign investors have not exactly been those of laissez-faire. Although China targeted and succeeded in attracting FDI, it is not a story of policy neutrality. Instead China used both carrots and sticks to attract FDI. On the one hand, favored foreign investors have been given special benefits such as tax preferences and favorable treatment with respect to the use of imported inputs and equipment for exporters; on the other hand, performance requirements have been imposed. Prior to China's recent entry into the World Trade Organization (WTO) these included performance requirements for local content, export performance, and foreign exchange balancing. Again the Moran view can be reconciled with the Chinese evidence by stating that the Chinese succeeded despite the sticks rather than because of them. It appears that over time, China has moved increasingly toward treating foreign investors more neutrally. While FDI in China was successful, perhaps the Chinese would have been even more successful had they applied more neutral policies earlier. But this country example shows that in practice it may actually be quite difficult to implement Moran's distinction between distorted and liberal regimes

in cross-sectional studies. Is China an example of a liberal regime or one that has engaged in considerable government intervention? Clearly it is a combination of the two.

In sum, therefore, all three are stimulating chapters. Taken together they highlight the importance of the overall context in which FDI occurs. However, much work is still needed to improve measurement of both outcomes and policy regimes.