

CHAPTER 7

INDUSTRIAL POLICY AND FOREIGN DIRECT INVESTMENT

FREDRIK SJÖHOLM

1. INTRODUCTION

Multinational firms (MNEs) are key actors in the global economy, accounting for more than one-fifth of global output and more than two-thirds of global trade (Qiang et al., 2020). Moreover, approximately one-third of global trade is between firms within the same MNEs (World Bank, 2020, p.33). MNEs also conduct a large part of private-sector R&D and are of crucial importance in developing new technologies. Sweden is part of this development with large outflows and inflows of foreign direct investments (FDI). For instance, foreign-owned firms account for one-fifth of the total private sector employment in Sweden (Tillväxtanalys, 2021).

Despite the importance of MNEs, the views on FDI differ between countries. The overall trend is that countries have become much more open to FDI in the last five decades. However, there has been a backlash to such liberalization in recent years. A previous strong desire to attract FDI is partly changing to more restrictions on FDI. This development can be seen as a demise of the Washington consensus, which encouraged free international capital flows and few if any restrictions on FDI. More negative attitudes toward FDI have corresponded with stagnating and even declining amounts of FDI. This stagnation is also seen in Sweden, where the foreign share of the economy has not increased in the last ten years (Tillväxtanalys, 2021).

The importance of MNEs is based on their characteristics; MNEs are large firms with high productivity levels. This strength has enabled firms to become multinationals and make investments in foreign countries, despite the high costs of

cross-border investments. It follows that a country can benefit from attracting these strong foreign MNEs. FDI will increase aggregate output and have other positive effects, such as increasing a country's involvement in global production chains and fueling the expansion of domestic suppliers. However, it is not easy to convince MNEs to invest in a country; MNEs tend to look carefully at different countries when deciding where to locate foreign affiliates. Hence, there is room and a need for industrial policies that increase FDI attractiveness.

Not all FDIs are equally beneficial for the host country. The MNE's behavior in the host country is important. For instance, MNEs that develop linkages with domestic firms will be more beneficial than MNEs that operate in isolated segments of the economy. Accordingly, MNEs that continuously upgrade their operations are of particular benefit to host countries. Hence, the second objective of industrial policy is to maximize the positive effects of FDI by providing an environment where MNEs, for instance, use local suppliers and bring in sophisticated technologies.

This chapter examines how FDI can contribute to growth and development in Sweden. We will draw upon the large empirical literature on FDI and from the experience of other countries. We start in section two with a description of how FDI has evolved in the last few decades. Section three summarizes the literature on FDI determinants and suggests several areas where industrial policies can be important. We continue in section four with a discussion on how policies can be used to maximize the benefits of FDI, and we conclude the chapter in section five.

2. GLOBAL FDI FLOWS

The growth in FDI increased rapidly in the late 1980s and the 1990s in particular, as seen in Figure 1. More precisely, FDI flows increased by more than 400 percent between 1990 and 1999. There are two main reasons for the growth in FDI. First, the global attitude toward FDI changed from largely negative to welcoming. This change coincided with a more favorable attitude toward globalization in general and a more hesitant view on regulations and import substitution.¹ The success of some of the early adopters on a development strategy based partly on foreign MNEs, notably some of the Southeast Asian countries, undoubtedly had an important impact on the policy change. Moreover, China opened up for FDI in the early 1990s, which had a large impact on global FDI flows because of China's large size and good conditions for manufacturing production.

1. Import substitution refers to industrialization and development with the use of tariffs and regulations to shield indigenous firms from foreign competition.

The second reason for increased FDI in the 1990s was the rapid development in communication over long distances. Computers and improved telecommunications have enabled surveillance of production chains that are spread out over countries and regions. Low and even falling trade costs spurred a fragmentation of production chains where some parts were being produced in foreign affiliates. Hence, firms pursue FDI as a way to place production of different parts in different countries.

Growth in FDI continued until the tech crisis in the early 2000s, severely negatively affecting FDI. However, the decline was relatively short-lived, and a new global peak in FDI was recorded in 2007. Levels of FDI declined again after the financial crisis in 2008–09, partly because banks and other financial institutions stopped providing credit for trade and investments (Bems et al., 2013). The financial crisis was largely over in 2010, but there was never any sustainable recovery of FDI. Instead, there was stagnation until the Covid-19 crisis in 2020.

This pandemic has had a sharply negative impact on FDI, which is not seen in Figure 1 because available data ended in 2019. However, FDI has been reported to have declined by 35 percent globally in 2020 (UNCTAD, 2021). This decline was substantially larger than the decline following the financial crisis in 2008–09, and FDI flows are now at the same level as in the 1990s. There are several reasons for the decline, one being that the pandemic increased uncertainty, which makes firms reluctant to pursue major investments. It also made travel more difficult, and travel is often necessary for the negotiations that precede a cross-country investment. Moreover, disturbances in global value chains occurred when factories were required to close down because of the pandemic. This made some MNEs concentrate and even reshore foreign production. Finally, profits have been falling in many MNEs, reducing FDI since reinvested profits are an important part of registered FDI flows.

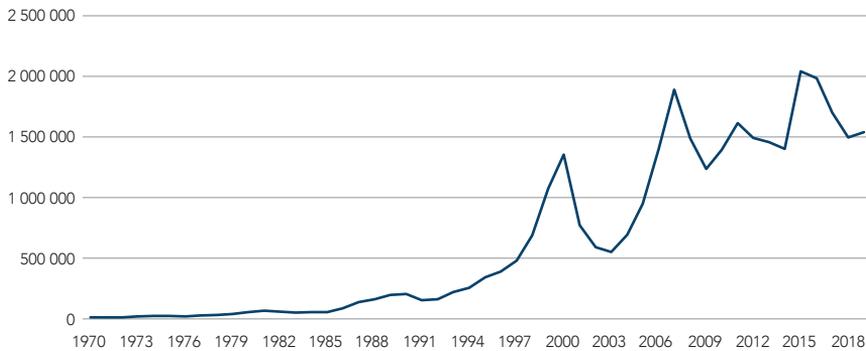
It seems that increased protectionism partly explains the stagnation in FDI. The positive views on globalization in the 1990s changed to more pessimistic views after the financial crisis. This was partly caused by the large income redistributions taking place as a consequence of increased globalization, which tended to hurt parts of the middle class in, for instance, the U.S. and the U.K. This had, in turn, political effects (Autor et al., 2020) and eventually contributed to both Brexit (Colatone and Stanig, 2018) and the U.S. trade wars.

The home countries of FDI have also changed over time with an increase from countries such as China. State-owned companies and sovereign wealth funds are also large sources of FDI. This has triggered fear among some host countries that FDI is not done only for commercial reasons (Cuervo-Cazurra, 2018). As a result, the screening of FDI to address risks to security or national interests, in general,

has increased substantially in recent years. Fear of being dependent on foreign powers for important goods and services, a desire to keep domestic technology within the country, and preventing sabotage of essential services are different aspects of these national security concerns and reasons for screening (Ufimtseva et al., 2020). Another argument for a more restrictive view that has gained broader support in recent years is that a country should not grant access to its domestic market if the same access for its own firms is restricted in foreign markets. This is a discussion that has become important in discussions on Chinese FDI.

There is also a discussion in many countries on the potential danger of being too dependent on global value chains, as it could increase vulnerability to foreign shocks and turbulence. One example is the development in Germany and the EU, described by Czernich and Falck in this volume. Policies are discussed and sometimes introduced to increase the domestic share of value-added, which harms globalization and FDI.

FIGURE 1. GLOBAL FDI FLOWS 1970–2019 (CURRENT PRICES MILLION US DOLLARS)



Source: <https://unctadstat.unctad.org/wds>

The change in attitudes toward FDI is seen in Table 1. It shows the number of policy initiatives that are favorable or negative for FDI. The number of policy changes, including restrictions and promotions, was higher before than after the financial crisis but has increased in recent years. The nature of these FDI policies has changed from a large share with a liberalizing aim to increasingly more policies aimed at restricting FDI. More precisely, more than five times as many policies liberalized the FDI regime than restricted the same regime five years before the financial crisis. The ratio declined to an average of 3,4 in 2008–2019 and saw a large drop to 1,4 in 2020. The absolute number of policies restricting FDI went from approximately 20–30 between 2003 and 2019 to 50 in 2020. Restrictions on FDI are now claimed to be the highest in 20 years and include a range of different measures (UNCTAD, 2019).

For instance, and as previously mentioned, the screening of FDI has increased, not least in the EU, which imposed a new framework for screening FDI in 2020. There has been a particular increase in screening in areas such as health-related industries. Moreover, Hufbauer et al. (2013) found an increase in various local content requirements after the financial crisis, clearly negatively affecting FDI.

TABLE I. CHANGES IN NATIONAL INVESTMENT POLICIES, 2003–2020

	2003–2007 (av.)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Number of countries that introduced changes	67	40	46	54	51	57	60	41	49	59	65	55	54	67
Number of regulatory changes	128	68	89	116	86	92	87	74	100	125	144	112	107	152
Liberalizations/Promotions	107	51	61	77	62	65	63	52	75	84	98	65	66	72
Restrictions/Regulations	20	15	24	33	21	21	21	12	14	22	23	31	21	50
Neutral/Indeterminate	1	2	4	6	3	6	3	10	11	19	23	16	20	30
Ratio Liberalizations/Restrictions	5.4	3.4	2.5	2.3	3.0	3.1	3.0	4.3	5.4	3.8	4.3	2.1	3.1	1.4

Source: UNCTAD (2021), Table III.1., p. 109.

3. THE EFFECT OF INWARD FDI ON ECONOMIC GROWTH AND DEVELOPMENT

To summarize the previous section, global FDI has increased substantially in a longer perspective. However, this development has changed due to the stagnation after the financial crisis and experienced a sharp decline during the pandemic. One crucial question to ask is whether this decline has any economic consequences. This brings us to a discussion on the economic impacts of FDI.

A discussion on MNEs and FDI might start from the observation that it is difficult to open up affiliates in foreign countries. Firms need to spend substantial amounts of money and efforts to do so. For instance, the firm needs to collect information on foreign rules and regulations, survey the country for good production facilities and qualified workers, and understand local preferences and tastes if the purpose is to sell its products locally. The firm needs to bear all of these costs before establishing foreign affiliates and receiving extra revenue from this FDI. Moreover, firms establishing themselves abroad need to compete with local firms with superior knowledge of local conditions. The MNE, therefore, needs a firm-specific advantage to compete, such as a superior technology, management, distribution network, or brand name. It follows that only relatively efficient and profitable firms can afford to take on the costs associated with FDI (Helpman et al., 2004). Empirical studies confirm that firms engaged in outward FDI are larger, more productive, and more

profitable than firms that restrict their activities to the domestic market (Temouri et al., 2008; Bernard et al., 2018).

The selection of good firms makes FDI attractive to many countries. Foreign MNEs will bring with them their superior firm characteristics, which could positively affect the host economy. Most importantly, foreign firms will raise output and income. This is obvious if there are idle resources in the country (unemployment), but it will do so even when this is not the case through a transfer of workers from local firms with relatively low productivity to foreign MNEs with relatively high productivity. This positive effect of FDI on the host economy will also benefit workers through higher wages (Lipsey and Sjöholm, 2004; Heyman et al., 2007), and it might benefit governments through increased taxes. However, the latter aspect is more uncertain, as MNEs typically pay relatively low corporate taxes (Davies et al., 2018). A network of affiliates in different countries makes it possible for MNEs to use transfer pricing to show high profits in countries with low corporate taxes and low profits in countries with high corporate taxes.

There are several other effects of FDI on the host country. For instance, foreign MNEs might use and thereby increase the output of local suppliers. Moreover, some MNEs provide support to suppliers, which will have a positive effect on productivity. Hence, foreign MNEs could benefit firms by providing inputs and components, including manufacturing and service sector firms. Another indirect effect will occur if some of the business practices and technology in foreign MNEs leak out to local firms. This externality is often referred to as “spillovers” from FDI (Blomström and Kokko, 1998). One mechanism is if domestic firms become aware of technology and business practices when foreign MNEs establish themselves in the country and simply imitate the MNEs. Another mechanism could be if local business partners in joint ventures use the technology in other projects. The existing empirical literature is somewhat inconclusive but tends to find spillovers from FDI (Keller, 2021). Despite increased competition, it is unclear whether such spillovers benefit only local firms in up- and downstream industries or firms within the same industry as foreign MNEs (Görg and Greenaway, 2004).

Hence, FDI can be an important contribution to economic growth and development. However, it is difficult to say exactly how important and identify the exact mechanisms based on empirical studies. One reason is that the relationship between economic growth and FDI is complex. Causality is likely to run in both directions; FDI increases growth in host countries, but high economic growth attracts more FDI. The effect of FDI on economic growth also seems to vary between countries that differ in different institutional and socioeconomic contexts. For instance, a high level of human capital seems to increase the growth effect of FDI, perhaps by facilitating technology transfers and externalities (Su and Liu, 2016). Moreover, it seems likely that different types of FDI differ in their impact on the host country and

that countries at different stages of development benefit from different types of FDI. For instance, labor-intensive manufacturing has been of significant importance in many countries in earlier stages of development, whereas technology-intensive FDI might be of relatively large importance in high-income countries.

Moreover, one often distinguishes between three motives for FDI: market-, resource-, and efficiency-seeking FDI. The first is FDI, pursued to be close to a market where the firm wants to sell its products, and the second is done to gain access to natural resources. Efficiency-seeking implies that firms divide the production chain into different parts and place these parts in countries where it is most cost-efficient. Another distinction is between horizontal and vertical FDI, where the former replicates the home country operation in a foreign country while the second divides the production chain into different parts. As discussed below, different types of FDI can and do have different effects on the home country.

4. ENCOURAGING INFLOWS OF FDI

4.1 Restrictions and hurdles

The above discussion shows that there are positive host country effects of FDI. It follows that countries will benefit from implementing policies that are viewed favorably by MNEs. The first step is to allow MNEs to enter and abolish different types of restrictions. As previously discussed, many countries have restrictions on FDI, and restrictions have increased in the last decade. However, avoiding restrictions is a necessary but insufficient measure for attracting more substantial amounts of FDI inflows. The second step is to make it easier to invest in the country. Bureaucracy, red tape, and various forms of legislation can be major hurdles for FDI. Cumbersome business licensing and permit procedures negatively affect FDI (De la Medina Soto and Ghossein, 2013; Hufbauer et al., 2013). Examples of entry barriers include restrictions on hiring foreign personnel, discriminatory licensing requirements, approval by multiple government agencies, and requirements to provide detailed forward-looking information on various aspects of the operation (World Bank Group, 2017, pp. 22). The procedures and efforts required to establish a company vary substantially between countries (World Bank Group, 2017), and they negatively impact FDI inflows (Hufbauer et al., 2013). Hence, simplifying these procedures is an important way to improve the country's attractiveness for FDI.

One way to reduce barriers to FDI is to make bilateral or multilateral investment agreements (IIAs). Such agreements are based on the judgment that investments are good and that various policies can increase them. Areas and issues that are included in IIAs include the admission, protection, and treatment of FDI. A dispute settlement procedure is often included. A large part of IIAs is the attempt to increase transparency on rules and regulations and thereby reduce uncertainty for firms

interested in pursuing cross-border investments. However, the empirical literature does not provide strong evidence of a positive effect of IIAs on FDI volume (e.g., Yackee, 2009). One reason could be that IIAs are negotiated between countries that are well integrated in terms of cross-border investments; causality goes from integration to IIAs rather than the other way around. Another reason could be that cross-country studies fail to find any effect since there is significant heterogeneity between industries, countries, and types of IIA, a hypothesis that receives some support in the literature (Colen et al., 2014; Berger et al., 2013; Haftel et al., 2010).

It should be noted that many IIAs include problematic aspects. According to some observers, IIAs do not give sufficient rights to host countries and responsibilities to foreign investors (Sauvant, 2021). In particular, there are arguments that the restrictions on what economic and social policies host country governments can implement without compensating foreign investors are too severe. Therefore, some countries are renegotiating bilateral investment agreements, a development in which the EU has been particularly engaged (UNCTAD, 2021, pp. 108). How agreements can be designed to increase FDI and account for aspects such as corporate social responsibilities is now negotiated and discussed in several forums and international organizations (Sauvant, 2021).

4.2 Country characteristics and FDI

In addition to the legal framework, there are obvious country characteristics that foreign MNEs favor and an equally obvious variety of country characteristics that discourage FDI. Guidance on important country characteristics can be found in the existing literature on FDI determinants. However, one should bear in mind that there are two serious shortcomings with most of the empirical literature, which make strong policy recommendations difficult. The first problem is that the studies differ substantially in scientific quality. For instance, most papers measure correlations between FDI and host country characteristics rather than causal relationships. Few studies have used common tools for measuring causalities, such as instrumental variables, regression discontinuity, and natural experiments.

The second methodological problem concerns data on FDI. Most studies on FDI suffer from a problem with measurement errors. There are a few studies using industry- or firm-level data on output to measure determinants of FDI; however, most use financial flows from the balance of payments data, which are affected by various factors and only have a weak link regarding actual production by MNEs (Lipsev and Sjöholm, 2011). FDI flows in balance of payments data often do not originate from the countries to which they are attributed, do not enter the countries that are their supposed destinations, and, if they do enter the declared destinations, do not remain in those destinations. They often represent bookkeeping entries in corporate accounts but no economic activity, such as employment, the production of goods

and services, or the installation of capital assets. For instance, many tax havens are among the largest receivers of FDI, although no actual production in MNEs occurs in these countries.

From the discussion above, it is clear that there is room for more research on FDI determinants, research that will attempt to estimate causal effects using appropriate methodologies and data. Because of the caveats above, the variables included in Table 2 are a somewhat subjective literature assessment.

Some country characteristics can be seen as exogenous to the country, outside the control of governments and policy-makers, and others as endogenous or affected by economic policies. The distinction is a simplification in the sense that it might be possible to change some exogenous variables. For instance, market size is one of the most robust factors affecting FDI inflows. Whereas the size of a country is difficult to change, better infrastructure will make the domestic market more integrated and larger, and regional integration might make foreign firms treat the country as part of a larger market.

Other exogenous characteristics include a strong geographic aspect; FDI flows are relatively high between countries located nearby. This has meant that some countries and regions benefit from being located close to large home countries of MNEs. For instance, Southeast Asia has received large amounts of FDI from Japan, Mexico from the U.S., and East Europe from the EU. Accordingly, the neighboring Nordic countries are large home countries of FDI to Sweden. There are different reasons for a strong geographic component in FDI. A short geographic distance typically means large similarities in preferences, culture, and other factors, positively impacting FDI. Moreover, MNEs prefer to have foreign affiliates within the same time zone and close enough to make traveling and visits easy. Finally, short distances reduce transport costs, which is another positive determinant of FDI, especially for efficiency-seeking FDI.

TABLE 2. HOST COUNTRY DETERMINANTS TO INFLOWS OF FDI.

Type	Variable/Host-Country Characteristics	Effect
Exogenous	Geography	Relatively large FDI inflows from nearby countries
	Market Size	Large countries receive large FDI inflows
Endogenous	Taxes	Low taxes increase FDI inflows
	Labor Costs/Productivity	Low wages and high labor productivity increase FDI inflows
	Human Capital	High human capital endowments increase FDI inflows
	Stability	High economic and political stability increase FDI inflows
	Infrastructure	Good infrastructure increases FDI inflows
	Openness to Trade	Openness increases FDI inflows

From a policy perspective, it is more interesting to look at the endogenous variables. Several such country characteristics are seen in Table 2.

Low taxes increase FDI. The effect of low taxes is perhaps surprising in light of our previous discussion on the ability of MNEs to avoid taxes through transfer pricing. Taxes seem to matter most for location decisions among countries that are similar in other respects, and low taxes cannot compensate for a poor and unattractive investment climate (Echandi et al., 2015, pp. 14–15). One example is that FDI to the U.S. declined substantially between 2017 and 2019, although corporate taxes were cut from 35 percent to 21 percent (Djankov and Zhang, 2020). The cut in tax rates could not balance other aspects that were seen as negative by foreign MNEs, such as increased tariffs and nontariff barriers.

The estimated elasticities, or how much FDI declines when taxes increase, vary between studies. It seems that the effect is larger in Europe than in most other places. For instance, in a slightly dated study, Desai et al. (2002) found that a ten percent higher tax rate in Europe is associated with a 7,7 percent decline in FDI inflows. Not only do corporate taxes matter for FDI, but in fact, some other taxes might be more important since MNEs are good at moving profits to countries where corporate taxes are low. Other taxes are more difficult to avoid and therefore relatively important for location choices. This could, for instance, include environmental taxes. Moreover, empirical studies have found effective average tax rates, effective marginal tax rates, and statutory tax rates to impact FDI (Echandi et al., 2015, pp. 14). Finally, different types of FDI are more or less sensitive to taxes. Empirical studies tend to suggest that efficiency-seeking FDI tends to respond most to taxes (Azémar and Desbordes, 2010).

Labor costs are important for FDI. However, the cost and wages should be shown in relation to the productivity of the labor force. Hence, it is the per-unit cost of production that matters for FDI rather than the wages themselves. Moreover, the importance differs between different types of FDI. Compared to MNEs that open foreign affiliates to sell on the domestic market, efficiency-seeking FDI is more sensitive to labor costs.

Labor productivity is affected by a range of factors, including human capital, which is found to have a positive effect on FDI; foreign MNEs are attracted to countries with well-educated populations. However, the discussion in the literature on the roles of human capital and education is rather vague. For instance, what does a skilled labor force mean? Is it a pool of experienced and well-trained workers, a highly

educated population, or something else? There seems to be a need for more research on how skills affect FDI since the literature provides little guidance on these issues.²

Infrastructure is found in many studies to positively affect FDI. However, infrastructure is another vague concept that includes different aspects. Different types of infrastructure are presumably important for different types of FDI. Some firms might be concerned about ports and airports connecting the host country to the rest of the world, whereas others are more interested in the domestic transport system. Others yet might look at some detail on the cost and reliability of electricity supply.

Openness to international trade is important for FDI in most empirical studies (e.g., Görg and Labonte, 2012), even though the theoretical effect of increased openness is unclear. More precisely, FDIs and exports can sometimes be substitutes rather than complements; firms might choose between serving a foreign market through exports or a foreign affiliate. High tariffs will make exports more expensive, and the firm will then choose FDI. However, a more important and dominating factor is that MNEs are trade intensive: they export more of their output and import more of their inputs than local firms (e.g., Bernard et al., 2018). This is, of course, most pronounced in MNEs that have divided up the value chain and produce inputs and components in different countries; however, it is also the case for other types of FDI. Hence, trade barriers will make the operation of MNE networks more difficult and expensive, which will discourage them from investing in the country.

Conflicts and turmoil are typically found to be negative for FDI. This is the case regarding economic turbulence but also concerning political and social turbulence. Economic instability includes high and volatile inflation and deep recessions. Political instability includes dramatic changes in political power or the policies favored by different parties. Exactly how important stability is for FDI is difficult to judge from the literature, but surveys by the World Bank found that investors regard political risk as one of the main negative aspects they consider (MIGA, 2014). It seems reasonable that the importance of stability differs between different types of FDI. Moreover, it is also reasonable to assume that stability is more of an issue for FDI in developing rather than developed countries.

The discussed policies are not discriminatory; they will benefit foreign and domestic firms alike. Hence, a key conclusion is that the most important policies to attract FDI are the same policies that encourage domestic firms and domestic entrepreneurship. A good business environment will bring strong domestic and foreign firms alike in the many different dimensions described above. However, one difference between local firms and MNEs is that MNEs have more location choices than domestic

2. Many studies use the share of the population with university education as a way to measure skills, and this variable has a positive effect on FDI.

firms, at least in comparison to small domestic firms. More specifically, MNEs are relatively good at locating where the conditions are best, whereas domestic firms face larger hurdles and are more constrained in location decisions. Hence, a poor business environment will presumably have a larger negative impact on FDI inflows than domestic business activities.

Moreover, some policies will impact the inflows of FDI but not necessarily on domestic firms. The provision of information is one such aspect. Foreign firms know less about a country than domestic firms. Host country governments can provide information and help foreign MNEs on various practicalities for investments to overcome this hurdle for FDI. Most countries have such agencies, and some countries have spent large amounts of money providing help to foreign firms. It seems reasonable to assume that such activities positively affect FDI, but the magnitude of the effect is unclear.

A related policy measure is subsidies for MNEs located in the country. Such support is common and has been in place for a long time in, for instance, the EU, the US, and many other developed countries (Echandi et al., 2015, pp. 15). The reason behind subsidies is a belief that the social value of investments is larger than the private value. In other words, society is to gain more from FDI than what is captured by production by the firm. Studies on such financial incentives suggest that the effect on FDI is, at best, very limited. For instance, Wren and Jones (2011) examine a large program in the UK that provided grants to FDI located in some specific areas. The estimated effect was positive but very small.

The discussion above is based on results from econometric studies. An alternative approach is to distribute surveys among firms and ask about important factors behind investment decisions. Such surveys have the advantage that they can capture more subtle aspects that are difficult to measure in econometric studies. One example of a survey-based paper is Ohmic and Stephenson (2019), who survey firms and IPAs. They find that aspects such as transparency and predictability of investment measures, streamlined and fast administrative procedures, and requirements, and arrangements to enhance coordination and cooperation are viewed as important determinants of the location of FDI.

5. MAXIMIZING THE BENEFITS OF FDI

5.1. Choosing the type of FDI

The discussion above describes some important determinants of FDI. A host country government might also be interested in attracting specific FDI types that are seen as being particularly valuable. Approximately 70 percent of all countries target specific industries (Charlton et al., 2004). Moreover, policy-makers are interested in

attracting FDI and maximizing the host country's benefits by affecting the MNE's behavior. Hence, there is room for policies that improve upon conditions crucial for some types of (valuable) FDI and policies that affect the behavior of entering MNEs. The latter could, for instance, include collaboration with local firms, technology transfer, and industrial upgrading. Again, this is important if the economic effects differ between different types of FDI. Previous studies suggest that this is the case; the growth effect of FDI depends on aspects such as, for instance, the MNE's skill intensity, suggesting that targeting might be appropriate (Alfaro and Charlton, 2013). It should also be noted that the perceived value of FDI might not be restricted to economic aspects but could include, for instance, social aspects. FDI that has a broader positive impact on the host country is sometimes referred to as "sustainable FDI" (Sauvant and Gabor, 2021) or "quality FDI" (OECD, 2019).

Two different factors are typically taken into account when the value of a particular FDI is being discussed. The first is the degree of possible externalities. High-tech MNEs tend to be viewed as valuable because of presumed technological spillovers. Host governments hope that technology-intensive FDI will spur the development of a domestic high-tech industry. Whether technology-intensive FDI is truly more valuable than other FDIs is questionable and seems to depend on the context: the host country must have the right conditions for utilizing and benefitting from technology-intensive FDI, for instance, through a sufficiently skilled workforce and sufficiently developed domestic firms.

Job creation from FDI is another aspect that is often looked upon. MNEs create many jobs in comparison to local firms (Lipsey et al., 2013), and MNEs contribute to a substantial share of total employment in most countries; for instance, 22 percent of total private industry employment in the U.S. and 6,4 percent of total urban employment in China (Qiang et al., 2020).

Job creation is often an argument used by policy-makers in favor of subsidies to FDI. However, subsidies to FDI can sometimes amount to huge sums for every new job. Delevic (2020) reported that Nissan received subsidies amounting to 11 000 USD per new job when it established an automotive factory in the U.S., and Subaru received 50 000 USD per job for a similar establishment. Moreover, India gave subsidies to Ford amounting to over \$200 000 per job created in a new factory (Thomas, 2010). These huge sums could be justified only if there is a crowding-in of jobs (i.e., if the new factory increases employment in many other firms). It is unclear whether such crowding-in typically occurs, at least to the magnitude that would make cost-benefit analysis justify the subsidies. Delevic (2020) found no effect on employment in Serbia beyond subsidized jobs (i.e., there is no additional job creation).

Hence, externalities from high-tech industries or job creation are two aspects that are often important in shaping the FDI policies of a country. One difficulty with an

overly strong focus on, for instance, externalities is that it might make governments target firms in industries where the country has no clear competitive edge and where the externalities, therefore, never materialize. An alternative approach is to favor FDI in industries where the country already has a strong base. In other words, the host country tries to strengthen already established clusters by encouraging FDI within the same industry or in industries with backward and forward linkages to the industry.

The work in attracting FDI is often organized by investment promotion agencies (IPAs). According to the World Bank Group (2017, pp. 18), more than 200 national IPAs and approximately 2 000 local IPAs are part of subnational governments. IPAs are typically organized around targeted industries with specialized staff working in these different units. Many IPAs offer investment incentives and investor facilitation to firms in targeted industries (Alfaro and Charlton, 2013).

5.2. Affecting the behaviors of MNEs

The benefits of FDI increase if the foreign MNE becomes rooted in the local economy, for instance, by using local suppliers. Linkages will increase output and employment in local firms and involve flows of tangible and intangible assets (UNCTAD, 2001). Alfaro-Urena et al. (2020) examine the effect of linkages with MNEs in Costa Rica. The positive effect on local firms is relatively large; they grow in size, increase productivity, and start selling their products to other new buyers. The positive effect is caused by MNEs demanding that local suppliers improve management, change sourcing strategies, and hire more skilled workers.

Most MNEs seem to have relatively few direct linkages of this sort with the local economy, even in developed countries. This is particularly true for relatively new FDI, whereas linkages might materialize and expand over time under the right conditions. For instance, Scott-Kennel (2007) examines linkages between MNEs and local firms in New Zealand. Only around 14 percent of MNEs are classified as having a broad set of linkages with the local economy. The number of linkages was positively related to the age of MNEs and affected by the line of businesses.

Moreover, different types of FDI are associated with different amounts of linkages. Market-seeking FDI tends to develop more forward and backward linkages with local firms than a resource- or efficiency-seeking FDI (Farole and Winkler, 2012; Sánchez-Martín et al., 2015). Efficiency-seeking FDI is often viewed as particularly valuable for host countries since it enhances participation in global value chains. However, high-quality suppliers are typically required for efficiency-seeking FDI to materialize since that is necessary for MNEs to compete globally.

There is a role for governments to play in developing linkages, mainly because of market failures, such as asymmetric information. MNEs highlight good information

about local suppliers as important for locating their foreign operations (Omic and Stephenson, 2019). Accordingly, local firms might need help to gather information on the presence of MNEs and what their demand for inputs looks like. It is costly and cumbersome for individual firms to collect such information. IPAs can play an important role simply by providing information on potential suppliers to MNEs and information on potential customers to local firms, for instance, through an accessible database. In addition, more active work to match MNEs with local suppliers can be pursued. Some countries have successfully invested significant effort into such activities. For instance, the development of Singapore's strong electronics industry was enhanced by a government program that matched local suppliers and foreign MNEs, hoping that such meetings would develop into a mutually beneficial collaboration (Brown, 1998).

Some governments instead try to force through linkages between MNEs and local firms. The local content requirement is often used in developing countries, although they tend to be prohibited by the WTO (Echandi et al., 2015, pp. 27). The intention is that local content requirements should accelerate the integration of foreign MNEs with the local economy. However, its benefits are highly questionable since it tends to make more competitive MNEs shy away and invest in other countries. This is the case for efficiency-seeking FDI in particular, where any policy that runs the risk of increasing the cost of production will discourage MNEs. Hufbauer et al. (2013) examined the effect of 117 local content requirements worldwide and found that it negatively affects FDI, trade, and employment.

Instead of policies trying to force MNEs to engage with local firms, local firms need to upgrade their operations and compete internationally to become of interest as suppliers to MNEs. There are several advantages for MNEs using local suppliers. For instance, it might reduce trade costs, and locally produced input goods might help adapt products for the local market. Hence, MNEs will use local suppliers if they can. However, MNEs often indicate that lack of direct linkages with domestic suppliers is caused by the poor quality of inputs, poor cost-competitiveness of suppliers, or poor reliability of supply (Jordaan et al., 2020, pp. 7). This is particularly the case with FDI in developing countries, but similar issues are also considered when firms decide between investments in different developed countries. MNEs perform a simple cost-benefit analysis when they decide on their sourcing strategies, and the poor quality of suppliers or even uncertainties regarding the quality make it less likely that sourcing will be local. Governments might reduce uncertainties by providing quality and certification schemes for local producers. Moreover, government organizations can complement efforts by MNEs and local suppliers and together strive for a broad and competitive supply base. It seems that such programs rely on the active engagement of all three parties to be successful: the host country government, local suppliers, and foreign MNEs (UNCTAD, 2001). In particular, cost-sharing increases the commitments of participating firms.

Erchandi et al. (2015, pp. 25) argue that host countries can improve upon linkages by paying attention to aspects such as the “learning and innovation infrastructure, trade policy business and investment climate, access to finance, and labor market regulations”. Regarding the mentioned Singapore case, government-supported local firms’ quality upgrading programs occur in various ways (Brown, 1998). Moreover, MNEs had managers working full time in conjunction with the supplier to improve quality, which benefitted both suppliers and MNEs.

Finally, it is desirable with FDI that strive to upgrade production over time to increase productivity and avoid industrial stagnation. Such upgrading will depend on the context and takes place if there is, for instance, a sufficient skill base in the host country. The host country’s government has an important policy role in providing an environment prone to quality upgrading.

Some studies also suggest that tax incentives to MNEs that upgrade their production, for instance, by introducing new products and direct R&D support, might have positive impacts (Brown, 1998), but the issue needs to be addressed in more general cost-benefit frameworks.

Again, the choice of activity taking place in a country by MNEs will rest on simple comparisons of costs and benefits. Hence, technology upgrading will take place if it is profitable. MNEs will avoid bringing in new technology if it is less suitable for the local conditions or risk losing it to domestic competitors. This highlights the importance of domestic institutional factors for how MNEs behave. The protection of intellectual property rights and good juridical systems increases the likelihood for MNEs to upgrade production over time.

Finally, the above discussion focuses on linkages between MNEs and local backstream suppliers. It can also be beneficial for countries to attract MNEs in support industries. Such MNEs will make downstream firms, local and foreign, more competitive. It will also contribute to the network of firms and create dynamic clusters. Clusters are important for attracting other MNEs to the country.

6. CONCLUDING REMARKS

FDI has the potential to spur growth and development in the host country. MNEs are larger and more productive than local firms, pay higher wages, and are integrated into global value chains. Policy-makers should, therefore, think carefully about how they can attract MNEs to the country. The context matters for FDI policies: policies suitable for developed countries differ from those suitable to attract a different type of FDI in developing countries. Our discussion offers some suggestions on what policies are important for a country such as Sweden.

The first conclusion from the literature review on FDI determinants is that any improvements in the general business climate will positively affect the inflows of FDI. Hence, good economic policies will benefit both domestic firms and attract inflows of FDI. Such policies include improvements in education, not substantially higher taxes than neighboring countries, good infrastructure, stable macroeconomic policies, and an open trade regime. The quality of education in Sweden has deteriorated in recent decades, and the debate on how to change this development is very active. Poor education will first and foremost be negative for wages and living standards. Our survey shows that it will also harm the inflows of FDI. Taxes in Sweden are high, although they have declined in recent decades. In particular, income taxes remain higher than in most other countries. This will have a negative impact on FDI, partly because it makes it more difficult to transfer foreign personnel to Swedish affiliates. Infrastructure is an area where large investments will be necessary for the years to come, not least concerning roads, railroads, and electricity systems. Moreover, Sweden has had large economic and political stability since the economic crisis in the early 1990s. Public debt and inflation are low, and economic growth has been comparably high. Finally, trade policy is decided at the level of the EU. Sweden has traditionally been an advocate for a liberal trade regime. Unfortunately, it is plausible that this view has lost strength with the exit of Great Britain, another free-trade champion. New alliances have been formed, but it is quite likely that the EU will be less open in the future.

Other factors affect MNEs more than domestic firms. For instance, good FDI policies would focus on abolishing various regulations and red tape that can be cumbersome and cause MNEs to invest in other countries. Finally, it can be difficult for MNEs to gather good information, which means that government agencies (IPAs) have a role to play. This is probably more important in developing countries than in more developed countries such as Sweden. Nevertheless, IPAs such as Business Sweden have a role to play and can be particularly important for investment from small- and medium-sized foreign firms, which may lack resources to collect the necessary information.

Attracting FDI can be seen as a first step, ideally followed by policies aimed at maximizing the benefits of having foreign MNEs located in the country. Such policies should aim to make MNEs develop linkages with the local economy and continuously upgrade their activities in the country. The first requirement is the right conditions for such linkages to develop. This means FDI in industries where Sweden has good conditions for production and growth. It is unlikely that more substantial linkages will develop if a good supply base does not already exist. The government can play an important role in implementing policies that foster competitive suppliers. These are similar to the general good business climate discussed above. Finally, there might also be a matchmaking role for the government; the

likelihood for linkages will increase if foreign MNEs and local suppliers are aware of each other's existence.

REFERENCES

- Alfaro, L. and Charlton, A. (2013). "Growth and the Quality of Foreign Direct Investment". In Stiglitz, J. E. and Yifu Lin J. (eds.). *The Industrial Policy Revolution I*, International Economic Association Series, Palgrave Macmillan, London.
- Alfaro-Urena, A., Manelici, I. and Vasquez, J. P. (2020). "The Effects of Joining Multinational Supply Chains: New Evidence from Firm-to-Firm Linkages", mimeo, Princeton University.
- Autor, D., Dorn, D., Hanson, G. and Majlesi, K. (2020). "Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure", *American Economic Review*, 110(10), 3139–83.
- Azémar, C. and Desbordes, R. (2010). "Short-run Strategies for Attracting Foreign Direct Investment," *World Economy*, 33(7), 328–357.
- Bems, R., Johnson, R. C. and Yi, K-M. (2013). "The Great Trade Collapse", *Annual Review of Economics*, 5(1), 375–400.
- Bernard, A. B., Jensen, J. B., Redding, S. J. and Schott, P. K. (2018). "Global Firms", *Journal of Economic Literature*, 56(2), 565–619.
- Berger, A., Busse, M. Nunnenkamp, P. and Roy, M. (2013). "Do Trade and Investment Agreements Lead to More FDI? Accounting for Key Provisions Inside the Black Box", *International Economics and Economic Policy*, 10(2), 247–275.
- Blomström, M. and Kokko, A. (1998). "Multinational Corporations and Spillovers", *Journal of Economic Surveys*, 12(3), 247–277.
- Brown, R. (1998). "Electronics Foreign Direct Investment in Singapore: A Study of Local Linkages in "Winchester City,"" *European Business Review*, 98(4), 196–210.
- Charlton, A., Davis, N., Faye, M., Haddock, J. and Lamb, C. (2004). "Industry Targeting within Foreign Investment Promotion", Oxford Investment Research Working Paper.
- Colantone, I. and Stanig, P. (2018). "Global Competition and Brexit", *American Political Science Review*, 112(2), 201–218.
- Colen, L., Persyn, D. and Guariso, A. (2014). "What Type of FDI is Attracted by Bilateral Treaties?", Discussion Paper 346/2014. LICOS Centre for Institutions and Economic Performance; Leuven.

- Cuervo-Cazurra, A. (2018). “Thanks but No Thanks: State-Owned Multinationals from Emerging Markets and Host Country Policies”, *Journal of International Business Policy*, 1(3–4), 128–156.
- Davies, R. B., Martin, J., Parenti, M. and Toubal, F. (2018). “Knocking on Tax Haven’s Door: Multinational Firms and Transfer Pricing”, *Review of Economics and Statistics*, 100(1), 120–134.
- De la Medina Soto, C. and Ghossein, T. M. (2013). “Starting a Foreign Investment Across Sectors”, Policy Research Working Paper 6707. World Bank, Washington, D.C.
- Delevic, U. (2020). “Employment and State Incentives in Transition Economies: Are Subsidies for FDI Ineffective? The Case of Serbia”, *Transnational Corporations*, 27(2), 31–63.
- Desai, M. A., Foley, C. F. and Hines, J. R. Jr. (2002). “Chains of Ownership, Regional Tax Competition, and Foreign Direct Investment”, NBER Working Paper No. 9224.
- Djankov, S. and Yiwen Zhang, E. (2020). “The Recent Fall in FDI Flows to the US”, VOX, 4 December, <https://voxeu.org/article/recent-fall-fdi-flows-us>.
- Echandi, R., Krajcovicova, J. and Qiang, C. Z. (2015). “The Impact of Investment Policy in a Changing Global Economy. A Review of the Literature”, Policy Research Working Paper 7437. World Bank Group, Washington, D.C.
- Farole, T. and Winkler, D. (2012). “Foreign Firm Characteristics, Absorptive Capacity and the Institutional Framework: The Role of Mediating Factors for FDI Spillovers in Low- and Middle-Income Countries”, Policy Research Working Paper 6265, World Bank, Washington, D.C.
- Görg, H. and Greenaway, D. (2004). “Much Ado About Nothing? Do Domestic Firms Really Benefit from Foreign Direct Investment?”, *The World Bank Research Observer*, 19(2), 171–197.
- Görg, H. and Labonte, P. (2012). “Trade Protection During the Crisis: Does it Deter Foreign Direct Investment?”, *World Economy*, 35(5), 525–544.
- Haftel, Y. Z. (2010). “Ratification Counts: U.S. Investment Treaties and FDI Flows Into Developing Countries”, *Review of International Political Economy*, 17(2), 348–377.
- Helpman, E., Melitz, M. and Yeaple, S. (2004). “Exports versus FDI with Heterogeneous Firms”, *American Economic Review*, 94(1), 300–316.
- Heyman, F., Sjöholm, F. and Gustavsson Tingvall, P. (2007). “Is there Really a Foreign Ownership Wage Premium? Evidence from Matched Employer-Employee Data”, *Journal of International Economics*, 73(2), 355–376.
- Hufbauer, G. C., Schott, J. J., Cimino, C., Vieiro, M. and Wada, E. (2013). “Local Content Requirements: A Global Problem”, Policy Analyses 102. Peterson Institute for International Economics, Washington, D.C.
- Jordaan, J., Douw, W. and Qiang, C. Z. (2020). “Foreign Direct Investment, Backward Linkages, and Productivity Spillovers. What Government Can do

- to Strengthen Linkages and Their Impact”, *In Focus*, The World Bank Group, Washington, D.C.
- Keller, W. (2021). “Knowledge Spillovers, Trade, and Foreign Direct Investment”, NBER Working Paper 28739.
- Lipsey, R. E. and Sjöholm, F. (2004). “Foreign Direct Investment, Education, and Wages in Indonesian Manufacturing”, *Journal of Development Economics*, 73(1), 415–422.
- Lipsey, R. E. and Sjöholm, F. (2011). “South-South FDI and Development in East Asia”, *Asian Development Review*, 28(2), 11–31.
- Lipsey, R. E., Sjöholm, F. and Sun, J. (2013). “Foreign Ownership and Employment Growth in a Developing Country”, *Journal of Development Studies*, 49(8), 1137–1147.
- MIGA (Multilateral Investment Guarantee Agency) (2014). “World Investment and Political Risk 2013”, World Bank Group, Washington, D.C.
- OECD (2019). “FDI Qualities Indicators: Measuring the sustainable development impacts of investment”, OECD, Paris.
- Omic, A. and Stephenson, M. (2019). “What Can Governments Do to Facilitate Investment? A Menu of the Most Important Measures Identified Through Surveys”, Report, World Association of Investment Promotion Agencies and World Economic Forum.
- Qiang, C. Z., Liu, Y., Paganini, M. and Steenbergen, V. (2020). “Foreign Direct Investment and Global Value Chains in the Wake of COVID-19”, Private Sector Development Blog, World Bank, <https://blogs.worldbank.org/psd/foreign-direct-investment-and-global-value-chains-wake-covid-19>.
- Sánchez-Martín, M. E., De Piniés, J. and Antoine, K. (2015). “Measuring the Determinants of Backward Linkages from FDI in Developing Economies: Is it a Matter of Size?”, Policy Research Working Paper 7185, World Bank, Washington, D.C.
- Sauvant, K. P. (2021). “More Attention to Policies! Improving the Distribution of FDI Benefits: The Need for Policy-Oriented Research, Advice and Advocacy”, *Journal of International Business Policy*, 4, 244–261.
- Sauvant, Karl P. and Gabor, E. (2021). “Facilitating Sustainable FDI for Sustainable Development in a WTO Investment Facilitation Framework: Four Concrete Proposals”, *Journal of World Trade*, 55(2), 261–286.
- Scott-Kennel, J. (2007). “Foreign Direct Investment and Linkages: An Empirical Investigation”, *Management International Review*, 47(1), 51–77.
- Su, Y. and Liu, Z. (2016). “The Impact of Foreign Direct Investment and Human Capital on Economic Growth”, *China Economic Review*, 37, 97–109.
- Temouri, Y., Driffield, N. L. and Añón Higón, D. (2008). “Analysis of Productivity Differences among Foreign and Domestic Firms: Evidence from Germany”, *Review of World Economics*, 144, 32–54.
- Tillväxtanalys (2021). ”Svenska koncerner med Dotterbolag i Utlandet 2019”, Rapport 2021:03, Tillväxtanalys, Östersund.

- Thomas, K. P. (2010). *Investment Incentives and the Global Competition for Capital*, Springer Palgrave MacMillan, London.
- Ufimtseva, A., Shapiro, D. and Li, J. (2020). “How Coronavirus is Changing the Rules on Foreign Investment in Essential Areas”, *The Conversation*, May 5, 2021, <https://theconversation.com/how-coronavirus-is-changing-the-rules-on-foreign-investment-in-essential-areas-135660>.
- UNCTAD (2001). “World Investment Report 2001. Promoting Linkages”, United Nations, Geneva.
- UNCTAD (2019). “World Investment Report 2019. Special Economic Zones”, United Nations, Geneva.
- UNCTAD (2021). “World Investment Report 2021. Investing In Sustainable Recovery”, United Nations, Geneva.
- World Bank Group (2017). “Investment Policy and Promotion Diagnostics and Tools: Maximizing the Potential Benefits of Foreign Direct Investment for Competitiveness and Development”. World Bank, Washington, D.C.
- World Bank (2020). “World Investment Report (2020). Trading for Development in the Age of Global Value Chains”. World Bank, Washington, D.C.
- Wren, C. and Jones. (2011). “Assessing the Regional Impact of Grants on FDI Location: Evidence from U.K. Regional Policy, 1985–2005”, *Journal of Regional Science*, 51(3), 497–517.
- Yackee, J. (2009). “Do BITs Really Work? Revisiting the Empirical Link Between Investment Treaties and Foreign Direct Investment”. In Sauvant, K. P. and Sachs L. L (eds.), *The Effect of Treaties on foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows*, Oxford University Press, Oxford.