SECOND ITEM ON THE AGENDA

Working Party on the Social Dimension of Globalization

Investment in the global economy and decent work

1. The subject is potentially vast since it could refer to all investment, domestic and foreign, in the global economy. It would clearly be difficult to do justice to such a wide array of issues in a short paper. Therefore, the term “investment in the global economy” will be interpreted to mean cross-border investments (Foreign Direct Investment (FDI), Portfolio Investment, and other financial flows), which are an increasingly important feature of the ongoing process of globalization. This paper will review recent trends in such investments, trace their implications for decent work, and raise key policy issues for discussion by the Working Party. This will provide the basis for the Working Party to identify priority areas for future work by the Office.

I. Introduction

2. Cross-border investments have grown very rapidly. With respect to Foreign Direct Investment it has been estimated that annual flows have increased from US$57 billion in 1982 to US$1,271 billion in 2000. The book value of these investments, which gives an indication of the significance of international production in the global economy, increased sixfold from US$0.7 to 4.1 trillion between 1985 and 1995. Over the same period other cross-border financial flows have also increased rapidly, but they have been more volatile.

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1 These terms can be described as follows: “Foreign Direct Investment” (FDI) is characterized by the fact that it is made to establish a lasting interest in or effective management control over an enterprise in another country. “Portfolio Investment Flows” consist of equity flows (e.g. direct purchases of shares by foreign investors) and bond issues purchased by foreign investors. It is of interest to note that pension funds constitute a growing source of such portfolio investment flows.


than FDI flows. These flows to developing countries amounted to US$58 billion in 2000, about a quarter of the level of their FDI inflows.  

3. It is important to note, however, that most of these flows continue to be between the advanced countries. In the case of FDI, 79 per cent of the annual flows in 2000 were among these countries, a proportion that has increased significantly from the average level of 68 per cent during the period 1989-94. Nonetheless, the flows to developing countries have increased substantially in absolute terms (from US$60 billion in 1989-94 to US$240 billion in 2000). These flows also represent a significant source of total investment in these countries – FDI flows were equivalent to 13.8 per cent of Gross Fixed Capital formation in 2000.  

4. The distribution of these flows among developing countries also continues to be highly concentrated. The top ten developing country recipients of FDI accounted for 77 per cent of annual flows in 2000, a degree of concentration that has not changed since 1985. In contrast, the least developed countries receive a negligible share. The picture is broadly the same in the case of other cross-border investment flows. A few emerging market economies dominate the scene. For example in the year 2000, emerging market economies in Asia accounted for 77 per cent of all net portfolio investment flows to emerging markets.  

5. It is also important to note the changing context within which these flows are occurring. A basic point is that the technological revolution has been a main driver of these changes. In the case of FDI, the information technology revolution provided the enabling conditions for the growth of global production systems based on multi-country locations for different stages of production of a particular product. The new technology allowed greater and cheaper access to information on both input and output markets, reduced transaction costs and made management of a dispersed production network feasible. This growth of a global production system, generating cross-border shipments of inputs and components, has been reflected in the increasing share of intrafirm trade in total world trade. As a consequence, the link between investment and trade patterns is now significantly stronger. Another important effect of the technological revolution on FDI is that it has changed the characteristics of the typical multinational enterprise. Increasingly, it is intensive in the use of knowledge capital and is an exporter of managerial, engineering, and financial services. Reputations and trademarks are an important source of its competitive advantage, as is its growing role in research and development, and product and process innovation.  

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5 All the figures in this paragraph are from UNCTAD, op. cit.  
7 IMF, op. cit.  
6. These technologically driven developments have been accompanied by a radical change in the policy environment for FDI. There has been a worldwide shift in policy attitudes towards foreign investment. “During the last two decades, many emerging economies have dramatically reduced barriers to FDI, and countries at all levels of development have created a policy infrastructure to attract multinational firms. Standard tactics to promote FDI include the extension of tax holidays, exemptions from import duties, and the offer of direct subsidies. Since 1998, 103 countries have offered tax concessions to foreign corporations.”

10 In part, this could be explained by the disenchantment with import-substitution policies in the face of their evident failure. But it has also been driven by “optimism about the economic consequences of foreign investment, coupled with heightened awareness about the importance of new technologies for economic growth”.

11 On the latter point, it has also been pointed out that high-technology exports have been by far the most dynamic area of export growth and access to this as well as to other “technology intensive and dynamic areas of activity” that were part of “integrated production networks under the aegis of TNCs necessarily meant that countries had to invite TNCs (TransNational Corporations)”.

7. In the case of other investment flows some of the same technological and policy factors have also been at play. The new information technology enabled closer integration of financial markets by permitting continuous real-time information flows, reducing transaction costs, and making instantaneous financial transfers possible. Similarly, financial liberalization, especially the opening-up of capital accounts, played a significant role, even though this type of liberalization has not, so far, been as widespread as that towards FDI.

II. A global perspective

8. Within the standard models of international economics, increasing cross-border investments are usually viewed positively. They represent a desirable reallocation of global investment funds based on the presumption that investors are rationally following market signals that direct funds to uses with the highest returns in the global economy. World output and productivity is thus maximized.

15 Included within this view is also the notion that cross-border investments contribute to a narrowing of the income gap between rich and poor countries. Flows from capital-abundant high-income countries to capital-scarce developing countries should, in principle, accelerate development in the latter. At the same time this provides investors in rich countries with opportunities to earn higher rates of return and have a more diversified portfolio.


11 ibid.


14 Equally, however, there has been concern expressed by some groups in capital-exporting countries that these flows represent a reduction in investment and hence of employment in these countries. This concern over “delocalization” or the transfer of production from high to low wage economies generated a lively debate in the mid-1990s that has however become more muted nowadays.
9. This benign view has, however, to be tempered by noting several obstacles in the real world that block its full realization. The narrowing of the income gap between rich and poor countries as a whole has not so far occurred to any significant extent. As noted earlier, the flows of investment from rich to poor countries remains highly concentrated and most of the least developed countries remain marginalized from the process.

10. Another significant problem is that cross-border investments are not always directed to their most productive uses. This could arise where policy distortions in host countries direct capital into activities with a low social rate of return, even though private returns are kept artificially high by policy inducements. Several studies have indeed shown that “a significant portion of the FDI that has gone to developing countries in the past has been invested in activities that were not internationally competitive”. 15 But this problem has probably been reduced after the worldwide shift towards economic liberalization that has occurred in the past two decades.

11. Another systemic problem that has been highlighted is that “beggar-thy-neighbour” policies in the competition to attract foreign investment could lead to reduced benefits from these investments for host countries as a whole. This problem is often compounded by subnational competition among regional authorities in a country for large FDI projects. To date, the evidence on the severity of the problem is still tentative. A recent study of the issue concludes that “incentives-based competition can be intense, but the evidence – which is insufficient to draw more than tentative inferences – suggests the competition tends to be quite intense only in particular industries (e.g. automobiles) or for particular investment projects (especially large ones)” 16 With respect to the danger that countries could resort to the lowering of labour standards as an inducement to FDI, the same study concludes that “there is little evidence in support of the stronger versions of the ‘race to the bottom’ hypothesis regarding governments’ defence of labour and environmental standards. The evidence cannot tell us, however, to what extent competition to attract FDI is inhibiting a socially optimal raising of these standards”. 17 However, it also judges that the “danger of such races – or at least of increasing downward pressure on these standards – always exists”. 18 As such it would be prudent to consider collective international action to forestall a race to the bottom with respect to fiscal competition or labour standards. This is especially so in view of the fact that, in the case of labour standards, “there is no robust evidence that low-standard countries provide a haven for foreign firms”. 19

12. With respect to portfolio investments and bank lending a major problem is the existence of market failures in the international monetary system. These can lead to irrational investor behaviour and bouts of instability. In this case, the potential benefits from global investment to host countries can be significantly negated by financial crises.

13. Apart from the above considerations affecting the level, distribution, productiveness, and stability of investment flows, it is also important to examine the impact of these flows on both source and host countries. These impacts include those on inter- and intra-country

15 Graham, op. cit., p. 84.


17 ibid.

18 ibid.

income distribution. More importantly the operations of foreign firms can affect growth in the host country, the performance and prospects of domestic firms, as well as labour conditions and policies. These relationships also define the effects of cross-border investments on decent work.

III. Effects on decent work

14. Cross-border investment affects decent work through several channels. First, it supplements domestic investment in receiving countries and hence should normally increase output and employment. This is an important consideration for developing countries with low savings rates and which face constraints on domestic resource mobilization. On the whole, the evidence suggests that foreign investment does increase growth. For example, a recent study of the effects of different components of private capital inflows on the growth of 44 developing countries concludes that “foreign direct investment and portfolio equity flows exhibit a robust positive correlation to growth”. But it is significant to note that it also found that “portfolio bond flows are not significantly linked to economic growth” and that “in economies with undercapitalized banking systems, bank-related inflows are negatively correlated with economic growth”. This suggests that the form in which the capital inflow occurs is a relevant policy consideration. In principle, if the growth effect is positive, then so too should be the employment effect. It is possible, however, that the net employment effect could be negative if there is a strong crowding out effect on local firms and the number of jobs created by the foreign firms is lower than that of jobs lost. Employment creation by foreign firms could also be lowered if they introduce technology that is capital-intensive in relation to a country’s factor-endowments. However, even where the employment effect is negative, this may still be economically justified from a longer term perspective. This could be so if the displaced local firms were inefficient (and had no hope of eventually becoming fully competitive) or if the foreign firms generated strong linkage effects and productivity spillovers that raised the growth rate of output and employment over the longer run. The empirical evidence on this issue is, however, sparse and does not permit simple generalization.

15. Secondly, cross-border investments can potentially also raise the rate of growth if there are spillover benefits from the transfer of technology and skills to the local economy. In this case, it raises labour productivity and incomes and hence exerts a positive effect on decent work. On this issue, a recent review concluded that “there is weak evidence that FDI generates positive spillovers for host economies. While multinationals are attracted to high-productivity countries, and to high-productivity industries within these countries, there is little evidence at the plant level that FDI raises the productivity of domestic enterprises”. But this is based on only the very limited number of plant level studies that are available. On the other hand, there have been countries, such as Singapore and Ireland


21 ibid.


that have been highly successful in generating strong spillover effects through the right policies and institutional development. The main lesson learnt from the success stories is that the presence of local firms able to absorb the new technologies and respond to new demands is an essential precondition. In addition, policies to develop local education, training and technology systems and to build supplier networks and support institutions are also vital.

16. Thirdly, the operations and labour practices of foreign firms affect the quality of jobs of those employed by foreign firms. For example, concern has been raised both within the ILO 24 and elsewhere about poor or exploitative labour conditions and violations of basic worker rights in export processing zones and in industries linked to international production chains such as garments and footwear. While there has been evidence on specific cases of abuse, the lack of systematic data on the issue makes it difficult to gauge the true extent and severity of the problem. Action by the ILO to generate systematic and objective information on the issue would clearly be useful. It would allow for more informed debate and facilitate the search for effective solutions to the problem. However, in spite of this controversy over the sweated labour issue, it is generally agreed that the available information on employment conditions in multinationals indicates that, overall, they pay higher wages than local firms and demand relatively skilled labour. 25

17. Fourthly, foreign firms could also potentially affect the rest of the labour market if they account for a significant part of the total demand of particular categories of workers. In this respect there has been growing interest in the issue of the rise in wage inequality between skilled and unskilled workers in several developing countries. Although much of this interest has arisen in the context of the literature on trade liberalization, the role of multinationals has also been highlighted. 26 These enterprises mainly demand both highly skilled labour per se as well as labour that is relatively skilled in a developing country context, even though they are not considered to be so in an industrialized country. This drives up the skill premium unless the local supply for these categories of workers responds adequately to the increased demand. Since the supply response is typically inelastic there has been concern that the rising skill premium contributes to the crowding out of local firms. Foreign firms may also affect the labour market as a whole if they have successfully lobbied governments to change labour standards and policies. But, as mentioned in the earlier discussion of policy competition for FDI there is little systematic information available on this issue. Finally, more general employment effects could also occur if the labour practices of foreign firms exert a significant influence on those of local firms. Where the foreign firms introduce enlightened practices such as a positive attitude towards unionization, worker participation, social dialogue, working conditions, and investments in worker training, this would exert a positive influence on attaining decent work in the host country. Here, again the available information does not permit any simple generalization.

18. Fifthly, foreign firms can also have more generalized effects on employment, wages, and other aspects of decent work if their presence leads to a weakening of the bargaining position of workers relative to employers. The argument here is that foreign capital is more mobile and is becoming increasingly so with technological developments and increased

24 For example, the ILO Committee of Experts has been raising the EPZ issue over many years in relation to various Conventions.

25 Hanson, op. cit., Graham, op. cit.

competition to attract foreign investments. This endows them with the power to exercise or threaten to use the exit option in bargaining with workers and host governments. A particular aspect of this is that the government’s ability to tax highly mobile capital is limited and hence most of the tax burden falls on the immobile factor – labour. This in turn limits the government’s ability to fund programmes that promote decent work.

19. Finally, flows of portfolio investment and bank lending, especially short-term ones, can have a negative impact on decent work if they provoke financial crises. These crises typically lead to a large contraction in the real economy and widespread job losses. They have also occurred with increasing frequency in the past decade, although wide disagreement still exists as to the causes and appropriate remedies for this phenomenon. A related issue here is the implication of financial openness for macroeconomic policies. A particular concern that has been expressed is that financial openness restricts the ability of countries to use counter-cyclical macroeconomic policies to limit contractions in the real economy. As a consequence, the goal of full employment, a key element for achieving decent work, becomes more difficult to attain.

20. These other financial flows also impact on decent work through the way they are utilized by the borrowers in the receiving countries. In the case of government foreign borrowing the impact on decent work could go either way. If the additional funds are used effectively for productive investments in infrastructure, human resource development and social development, then the effect would be strongly positive. If, in contrast they are used unproductively to fund unsustainable fiscal deficits then the effect would clearly be negative since workers would ultimately bear the brunt of the burden of financial crises. A similar observation holds with respect to the foreign loans of local companies. In both these cases there is evidence from recent financial crises that imprudent borrowing by either governments or the private sector has been a significant causal factor.

21. The outcomes with respect to private sector foreign debt are determined to a large extent by the soundness of the domestic financial system. Premature financial liberalization before developing the capacity of governments to regulate the financial system and for the banking system to monitor and evaluate the soundness of foreign loans has proved to be unwise. Poor corporate governance has also been a significant problem in some cases.

22. The domestic financial system is also the transmission mechanism that determines the internal distribution of benefits from the increased access of developing countries to international capital markets. The degree of access it offers to small and micro-enterprises has an important bearing on the extent to which global financial flows promote the attainment of the objective of decent work for all. From this perspective, it would be clearly desirable to have a broad-based financial system that caters to small financial transactions, that integrates them into the supervised and regulated financial markets, that provides to poor households liquid, safe, remunerated deposit-taking facilities. This would make it possible to tap the huge savings potential in informal economy transactions,

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helping to close the domestic savings-investment gap. The ILO’s Social Finance Programme is working towards this end through its research and advisory work.

IV. Policies to harness global investments for decent work

23. The preceding discussion has highlighted a large policy agenda that needs to be addressed. In terms of international or systemic issues it would be clearly desirable, from the standpoint of promoting decent work, to have a stable international financial system that allocates investment efficiently to activities that are productive and generate decent jobs. But achieving this is a complex problem that involves issues that players in the multilateral system other than the ILO have the lead role. Nevertheless, the ILO has a useful role to play through the continued advocacy of the importance of taking into account the decent work objective in the design of a new international financial architecture, including the importance of listening to the voices of the social partners.

24. In would also be clearly desirable to have an international system where international labour standards are respected by all foreign and local firms alike. This would eliminate one major element of the controversy over the social impact of globalization. Here, the ILO is at the forefront of global action to achieve this goal through its regular supervisory machinery on international labour standards and its work in promoting the Declaration on Fundamental Principles and Rights at Work, the IPEC, and the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy. There are of course other proposed courses of international public action to achieve universal respect for core labour standards, such as that for a social clause in trade agreements and a multilateral agreement on investment. There is, however, no consensus on these issues within the ILO. In addition to these proposed international public actions there are also a variety of voluntary private initiatives (social labelling, the promotion of ethical investment and trade, and voluntary corporate codes of conduct) that impinge on the issue of global investment and decent work. Here again, a general ILO policy stance towards these initiatives remains to be defined.

25. National policies that would be effective in harnessing global investment for attaining decent work policies can be conveniently subdivided into those relating to the attraction of foreign investment and those directed at maximizing the net benefits from these investments. With regard to the first set of policies the following tentative conclusions are suggested by the preceding review of the literature and would appear to provide a useful starting point for the Working Party’s discussion of these issues:

(i) The fundamentals of a well-functioning market economy and good governance have to be in place before a country can even become eligible to receive foreign investment. An important part of these fundamentals is a sound investment climate that ensures property and other legal rights and that is free of unnecessary obstacles to enterprise creation, price distortions and macroeconomic instability. Without this, even if foreign investments are attracted, the net benefits from this will be meagre. In addition, another important prerequisite is a minimum threshold of human resource development. These considerations are particularly relevant to the least developed countries, which remain marginalized from global investment flows. International

assistance to supplement the national efforts of these countries to attain these preconditions is the key to overcoming this marginalization.

(ii) Incentive-based competition for foreign direct investment does not have a high pay-off. What is far more important is to increase a country’s attractiveness to investors through developing its infrastructure, creating a skilled and productive labour force, and an agglomeration of efficient local suppliers. Investments in an education and training system that is responsive to changes in the demand for skills are especially important not only for attracting investment but also for increasing the capacity of a country to capture the spillover benefits from foreign firms.

(iii) A similar observation to the above holds true for competition to attract foreign investment through the lowering of core labour standards. The available evidence indicates that this is unlikely to have any significant impact on the decisions of foreign investors. As such it constitutes needless and self-inflicted social and economic harm. While the social harm is evident, it is still not sufficiently appreciated that a sound industrial relations system based on full respect for fundamental worker rights increases a country’s attractiveness to investors. This is over and above its general benefits in terms of increasing economic efficiency, equity and social and political stability.

26. With respect to policies for maximizing the benefits from foreign investment, it would appear that the following propositions arising from the literature review could be usefully addressed by the Working Party:

(i) With respect to foreign direct investment, restraint with respect to the offer of fiscal and labour standard concessions would also contribute to maximizing the net benefits from these investments. This includes keeping subnational competition for FDI within sensible limits.

(ii) The past record with respect to the use of performance criteria such as local content, export, and technology transfer requirements shows that these have rarely been effective. A better option would be to concentrate on getting the fundamentals right with respect to the policy environment and the development of the local skill and technology development system. In terms of the policy environment it is particularly important to ensure coherence between trade and investment policies. The liberalization of investment policies without trade liberalization is likely to lower the gains from FDI especially with respect to export growth.

(iii) The above does not mean that there should be a total abrogation of policy instruments to target, guide and bargain with foreign investors. In many developing countries there are serious market failures with respect to the investment process that would justify the use of such instruments. Similarly, there are often divergences between the interests of multinational enterprises and those of host governments, as well as inequalities in bargaining power, that need to be narrowed. Hence the use of policy instruments such as rigorous project evaluation, regulation to correct anti-competitive behaviour, control over mergers and acquisitions by foreigners, and measures to stimulate linkages with local enterprises may be justified by particular country circumstances.

(iv) A key issue is whether policies to correct market failures should extend to the sheltering of infant industries from foreign investments. Advocates of this view point to the experiences of the Republic of Korea and Taiwan, (China) where restrictions on foreign investment were part of the successful strategy to achieve rapid industrialization and technological upgrading. It needs to be noted, however, that the opportunity cost of adopting such a strategy today is higher today than in the 1960s
and 70s when it was pursued by these two economies. This is because of the more important role of multinational enterprises, and of the knowledge-capital that they control in the international production system today. Acquiring technology and organizational know-how through means other than FDI (e.g. licensing) has also become more difficult and expensive. Moreover, there is also the well-known problem that industrial policy is difficult to get right and not many developing countries have the administrative capacity to achieve this.

(v) A similar concern has been raised in the context of the emerging multilateral framework of rules governing foreign investment. The perceived danger is that developing countries will increasingly lose their autonomy to pursue even sensible policies to correct for market failures that inhibits their industrial development. There is merit in this concern and exceptions and transitional arrangements for developing countries deserve serious consideration in the negotiations on multilateral investment regimes.

(vi) Labour policies should be a key component of policies to maximize the benefits from FDI and to harness it to advance decent work. Freedom of association and the right to bargain collectively will allow local workers to obtain a fair share of the benefits generated by FDI. A sound industrial relations system built on these foundations will provide the enabling environment for developing production systems that emphasize labour-management collaboration to raise productivity and the level of skills. These should be supported by public action to increase investments in training, to improve the responsiveness of training systems to changes in skill demands, and to provide the institutional framework (including public-private partnerships) and incentives for both local and foreign firms to upgrade worker skills.

(vii) Strengthening the labour-inspection system and the capacity to implement labour legislation will make a significant contribution to improving the benefits to workers from FDI. The elimination of poor working conditions and abusive labour practices will not only improve the welfare of affected workers but will also help to defuse hostility towards FDI.

(viii) Measures to reduce the social costs of adjustment to a more open investment regime should receive high priority. These measures include active labour market policies to assist displaced workers and the strengthening of social protection. Where such policy liberalization is likely to lead to large job losses among local firms, a gradual and phased strategy should be given serious consideration.

(ix) In the case of portfolio investment and bank-related loans a cautious approach to financial liberalization, especially of the capital accounts, is required. The preconditions of a sound and well-regulated domestic financial system and efficient macroeconomic and corporate governance need to be in place before this step is taken. This will reduce the risk of financial crises that seriously set back the attainment of decent work objectives. Measures to increase the accessibility of the domestic financial system to small and micro-enterprises will also be an important means of spreading the benefits from increased foreign investment more widely and equitably.