



SECOND ITEM ON THE AGENDA

**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),¹ 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 increased from US\$57 billion in 1982 to US\$1,271 billion in 2000.² The book value of these investments, which gives an indication of the significance of international production in the global economy, increased

* This document is an updated and revised version of GB.283/WP/SDG/2.

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.

² UNCTAD: *World Investment Report* (Geneva, 2002). These flows declined sharply (by 51 per cent) in 2001 due to the slow down in the world economy. This decline was far more severe in the industrialized countries; inflows to developing countries decreased by only 14 per cent. Such short-term swings in investment flows are linked to the business cycle and stock market sentiment and have occurred during previous downswings in the global economy. They do not reflect a change in underlying trends.

sixfold from US\$0.7 trillion to US\$4.1 trillion between 1985 and 1995.³ Over the same period other cross-border financial flows also increased rapidly, but they were more volatile 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.⁴

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 1989-94.⁵ Nonetheless, the flows to developing countries increased substantially in absolute terms (from US\$60 billion in 1989-94 to US\$240 billion in 2000 before falling to US\$205 billion in 2001 due to the global economic slowdown). 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 both 2000 and 2001.⁶
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 75 per cent of annual flows in 2001, a degree of concentration that has not changed since 1985. In contrast, the least developed countries receive a negligible share.⁷ 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.⁸ In view of this, domestic resource mobilization remains the critical means for raising growth rates in developing countries. This would be especially so if one accepts the argument that there are substantial amounts of “dead capital” that could be tapped through conferring and enforcing property rights in the informal economy.⁹
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 major driver of these changes in investment flows. 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

³ E.M. Graham: *Fighting the wrong enemy: Anti-global activists and multinational enterprises* (Institute for International Economics, Washington DC, 2000).

⁴ IMF: *International capital markets: Development, prospects and key issues*, Aug. 2001.

⁵ The share of FDI flows to advanced countries fell back to 68 per cent in 2001 because of the short-term changes described in footnote 2 above.

⁶ All the figures in this paragraph are from UNCTAD, op. cit.

⁷ *ibid.* For a discussion of the factors explaining this in the case of the least developed countries in Africa, see L. Ordenthal: *FDI in sub-Saharan Africa* (OECD Development Centre, Technical Paper No. 173, Mar. 2001) and E. Asiedu: *On the determinants of foreign direct investment to developing countries: Is Africa different?* (World Development, Jan. 2002), Vol. 30, No. 1, pp. 107-119.

⁸ IMF, op. cit.

⁹ H. de Soto: *The mystery of capital: Why capitalism triumphs in the West and fails everywhere else* (New York, Basic Books, 2000).

network feasible.¹⁰ 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. As such, in order to benefit from these “exports” it is essential that recipient countries invest in appropriate education and training to improve their capacity to absorb new technology and ‘know-how’. Reputations and trademarks are also an important source of the competitive advantage of the multinational enterprise, as is its growing role in research and development, and product and process innovation.¹¹

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.”¹² 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”.¹³ 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)”.¹⁴
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.

¹⁰ R. Narula and J.H. Dunning: *Industrial development, globalization and multinational enterprises: New realities for developing countries* (Oxford Development Studies, Vol. 28, No. 2, 2000).

¹¹ J.R. Markusen: *Foreign direct investment and trade* (Policy Discussion Paper No. 0019, Centre for International Studies, University of Adelaide, Apr. 2000).

¹² G.H. Hanson: *Should countries promote foreign direct investment ?* (UNCTAD, G-24 Discussion Paper Series, No. 9, Feb. 2001).

¹³ *ibid.*

¹⁴ S. Lall: *FDI and development: Research issues in the emerging context* (Policy Discussion Paper No. 0020, Centre for International Economic Studies, University of Adelaide, Apr. 2000).

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.¹⁶ At the same time this provides investors in rich countries with opportunities to earn higher rates of return and have a more diversified portfolio.
9. This benign view has, however, to be tempered by noting several obstacles in the real world that block its full realization. As noted earlier, the flow of investment from rich to poor countries remains highly concentrated and most of the least developed countries remain marginalized from the process. As a result, the contribution of cross-border investments to the reduction of the income gap between rich and poor countries as a whole has been weaker than predicted in the standard models of international economics.
10. One problem is the existence of policy obstacles to the free outflow of investments from developed countries. Many of these countries have in place policies such as locational incentives to attract foreign direct investment and anti-dumping measures that are sometimes misused for protective purposes. These constitute distortions to the free location of international investment. Domestic-content requirements within the European Union and NAFTA have also aggravated the problem.¹⁷
11. Similarly, policy distortions in developing countries have resulted in the fact that inflows of investment have not always been directed to their most productive uses. High levels of tariffs have led to inflows of foreign direct investment that have been attracted to these protected domestic markets that were closed to their exports. This directs FDI into activities with a low social rate of return even though private rates of return are kept artificially high by protection. Similarly policies such as domestic-content requirements and joint venture stipulations have sometimes also reduced the efficiency of foreign investment without achieving the broader developmental objectives that inspired the adoption of such measures. 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”.¹⁸ But this problem has probably been reduced

¹⁵ R.E. Caves: *Multinational enterprise and economic analysis* (Cambridge University Press, 1996).

¹⁶ 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.

¹⁷ T. H. Moran: *Parental supervision: The new paradigm for foreign direct investment and development* (Institute for International Economics, Washington DC, Aug. 2001), Policy Analyses in International Economics, No. 64.

¹⁸ Graham, op. cit., p. 84.

after the worldwide shift towards economic liberalization that has occurred in the past two decades.

12. 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)”.¹⁹ 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”.²⁰ However, it also judges that the “danger of such races – or at least of increasing downward pressure on these standards – always exists”.²¹ As such it would be prudent to monitor the situation and consider appropriate 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”.²²
13. 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.
14. 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 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

15. 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

¹⁹ C. Oman: *Policy competition for foreign direct investment: A study of competition among governments to attract FDI* (OECD Development Centre, 2000).

²⁰ *ibid.*

²¹ *ibid.*

²² OECD: *International trade and core labour standards* (Paris, 2000), p. 34. See also D. Kucera: *The effects of core workers’ rights on labour costs and foreign direct investment: Evaluating the conventional wisdom* (ILO, Decent Work Research Programme DP/130/2001).

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. An influential study using data on FDI flows from industrial countries to 69 developing countries over the period 1970-89 found that “FDI has an overall positive effect on growth, although the magnitude of this effect depends on the stock of human capital available in the host country ... for countries with very low levels of human capital the direct effect of FDI is negative”.²³ Another 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”.²⁴ 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”.²⁵ 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.²⁶ 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 term. The empirical evidence on this issue is, however, sparse and does not permit simple generalization.

16. 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”.²⁷ 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

²³ E. Borenstein, J. De Gregorio and J.W. Lee: “How does foreign direct investment affect economic growth?” in *Journal of International Economics* 45 (June 1998), pp. 115-135. The explanation of the negative effect of FDI on growth in countries with low levels of human capital derives from the fact that FDI contributes to growth more through raising productivity than through increasing domestic investment. “Thus, FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy.”

²⁴ M. Sotto: *Capital flows and growth in developing countries: Recent empirical evidence* (OECD Development Centre, Technical Paper No. 160, July 2000).

²⁵ *ibid.*

²⁶ For a dissenting view, see R. Hausmann and E. Fernández-Arias: *Foreign direct investment: Good cholesterol?* (Inter-American Development Bank, Research Department Working Paper No. 417, Mar. 2000).

²⁷ Hanson, *op. cit.* See also L.R. De Mello, Jr.: “Foreign direct investment in developing countries and growth: A selective survey”, in *Journal of Development Studies* (London), Vol. 34, No. 1, Oct. 1997.

Ireland that have been highly successful in generating strong spillover effects through the right policies and institutional development. A recent study based on the automotive and the computer/electronics sectors stresses the importance of being fully integrated into global production networks as an effective means of maximizing backward linkage and spillover benefits from foreign direct investment. “Foreign investors whose local operations comprise an integral part of the parent’s global or regional sourcing network introduce state-of-the-art technology and business practices into the host economy both via the investment that the parent company makes in the performance of its own subsidiary and via the supervision that the parent and the subsidiary exercise over the performance of local suppliers ... As a by-product of their own efforts to strengthen their competitive position in international markets, the foreign firms develop a major stake in the level of accomplishment of both the subsidiary and the suppliers upon which the subsidiary depends”.²⁸ 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.

17. Thirdly, the operations and labour practices of foreign firms affect the quality of jobs of their employees. For example, concern has been raised both within the ILO²⁹ and elsewhere about poor or exploitative labour conditions and violations of basic worker rights in some export processing zones³⁰ and in industries linked to international production chains such as garments and footwear. While there has been evidence of 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.³¹
18. There have been several new academic studies on this issue, reflecting a heightened degree of public interest in it.³² A major driving force has been the anti-sweated labour movement in the United States. Without entering into the controversy, it would nevertheless be of interest to the Working Party to be informed of a few salient points that have been made in the recent literature. It is of interest to note that there is general agreement in this literature on the desirability of eliminating these violations of core labour standards. But significant differences in views persist both on the objectives and the best means of action in this area. On objectives, a central point of contention is over

²⁸ T. H. Moran, op. cit.

²⁹ The ILO Committee of Experts has been raising the EPZ issue over many years in relation to various Conventions.

³⁰ For a more detailed discussion of labour conditions in export processing zones, see “Employment and social policy in respect of export processing zones”, GB.285/ESP/5.

³¹ Hanson, op. cit.; Graham, op. cit.

³² See, in particular, T.H. Moran: *Beyond sweatshops: Foreign direct investment and globalization in developing countries* (Brookings Institution, Washington DC, 2002); D.K. Brown, A.V. Dearnorff and R.M. Stern: *The effects of multinational production on wages and working conditions in developing countries* (paper presented at the CEPR/NBER/SNS Conference, International Seminar on International Trade on “Challenges to Globalization”, Stockholm, May 2002; and Graham, op. cit.

whether action to deal with the “sweated labour” problem should go beyond the issue of core labour standards and include the institution of a “living wage”. This is advocated by one group of activists, the National Labor Committee in the United States, and has some support from radical economists. There is, of course, no political support for such a notion at the international level. In addition, mainstream economists are strongly opposed to this on the grounds that such a wage would be difficult to define, that it is likely to be higher than the supply price of local labour and will hence restrict employment opportunities and impair the competitive position of developing countries. It has also been pointed out that raising wages through these means would lead to a reallocation of employment from developing countries with the lowest levels of wages and labour productivity to those where both these are higher. It is argued that this is likely to happen because the industries where the “sweated labour” problem is concentrated (mainly garments and footwear) are particularly “footloose”.

- 19.** In contrast to the differences on this issue, there is general support in the academic literature for the notion that voluntary private initiatives such as corporate codes of conduct and product labelling can have a positive effect. The underlying economic arguments are, first, that public opinion surveys indicate that a significant proportion of consumers in the industrialized countries are willing to pay a premium for products that are certified as having been produced under acceptable employment conditions. This provides a basic enabling condition for labelling schemes to work since consumers would finance at least part of the cost of improving employment conditions. Secondly, there is prima facie evidence³³ that multinational firms organizing the production and distribution of garments and footwear can easily afford to bear the costs of improved working conditions. Labour costs at the production stage are a tiny fraction (3 to 5 per cent) of the final retail price of the products in question.³⁴ The explanation given for this is that the multinational firms are “capturing oligopoly rents because of brand preferences, private labels and name recognition that they have established”.³⁵ Thirdly, in the face of adverse publicity generated by activist groups there is an incentive for multinational firms to improve employment conditions in their production networks.
- 20.** Differences of opinion do, however, remain on how much reliance should be placed on voluntary private initiatives. Sceptics have highlighted imperfections with these initiatives such as the lack of credible and autonomous monitoring of performance and the fact that labelling schemes can be undermined by counterfeiters. More fundamentally, there are serious doubts whether such initiatives can be of sufficient coverage and effectiveness to serve as anything more than a supplement to ongoing efforts within the international system to promote core labour standards. The scope of such initiatives is limited to multinational enterprises producing exports to developed countries and even within this sector the degree of compliance and effectiveness is uneven. These initiatives thus do not touch the majority of workers in developing countries who work for local firms or are self-employed. From this perspective, the promotion of core labour standards through the ILO Declaration on Fundamental Principles and Rights at Work is a far more

³³ It has been objected that such comparisons do not take into account the costs of further processing, transportation, advertising and distribution.

³⁴ The same is not true, however, of the typical independent subcontractors at the base of the production and distribution chain. For such firms, the local wage bill constitutes a high proportion of total production costs, so the feasibility of improving wages and working conditions would depend on these firms being paid higher prices for their output that are financed from higher stages in the production and distribution chain.

³⁵ D.K. Brown et al., *op. cit.*, p. 9.

powerful and generalized instrument. In particular, full respect for freedom of association and the right to collective bargaining would give all workers the essential means for improving their working conditions directly. More generally, it has also been argued that there is considerable scope for improving the working conditions of workers in developing countries through domestic policies that will increase economic efficiency, skills and worker productivity. An illuminating recent study using export processing zones in the Philippines, the Dominican Republic and Costa Rica as examples, shows that the movement from initially low-skilled to slightly higher skilled operations is the key to improving worker treatment in the developing world. The study argues that this transition can be greatly facilitated by worker training and other inducements to attract higher productivity firms. The better labour practices of these firms then exerts a positive demonstration effect on other pre-existing firms. Initiatives by government, employers' and workers' organizations, and trade unions to improve labour-management relations and promote more worker-friendly and productive forms of work organization also played a significant role in reducing the "sweated labour" problem.³⁶

21. 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.³⁷ 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 influenced labour policies in host countries. But, as mentioned in the earlier discussion of policy competition for FDI there is little systematic information available on this issue. 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.
22. 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 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.³⁸ 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.

³⁶ T.H. Moran, op. cit., 2002.

³⁷ See discussion of this issue in ILO: *Trade liberalization and employment*, GB.282/WP/SDG/2, 282nd Session, Nov. 2001 and GB.283/WP/SDG/1, 283rd Session, Mar. 2002.

³⁸ D. Rodrik and T. van Ypersele: "Capital mobility, distributive conflict and international tax coordination", in *Journal of International Economics* (Amsterdam), Vol. 54, p. 58.

23. 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.³⁹ 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.
24. 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 were 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 and other vulnerable social groups 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.
25. 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.
26. 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, helping to close the domestic savings-investment gap.⁴⁰ 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

27. International development assistance, especially to the least developed countries, can play a significant role in overcoming the current marginalization of the majority of developing

³⁹ See E. Lee: "Financial crises and employment", in C. Randzio-Plath (ed.): *Globalization of financial markets and financial stability* (Nomos Verlagsgesellschaft, Baden-Baden, 2002).

⁴⁰ D.M. Gross: *Financial intermediations: A contributing factor to economic growth and employment* (Social Finance Programme Working Paper No. 27, ILO, Dec. 2001).

countries from the benefits of foreign investment. By supporting the development of physical infrastructure and human resources as well as improvements in political and economic governance such assistance will contribute greatly to improving the attractiveness of these countries to foreign investment. In addition, the industrialized countries could consider various promotional mechanisms to attract potential investors to least developed countries that offer good investment opportunities but are unable to market themselves effectively. More generally, the industrialized countries can facilitate private capital inflows to developing countries through improving information flows to investors, strengthening insurance schemes, and providing greater market access to exports from developing countries. This should be supported by an increased role of multilateral development banks in co-financing and providing guarantees to foreign direct investment.

28. 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.
29. It would also be clearly desirable to have an international system where core 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 InFocus Programme on Child Labour: IPEC, and the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy. In addition, 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. A general ILO policy stance towards these initiatives remains to be defined.
30. 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 attractive to 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.

31. 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 not always 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. However, some observers have argued that the opportunity cost of adopting such a strategy is higher today than in the 1960s and 1970s 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. licencing) 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.

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