Overview

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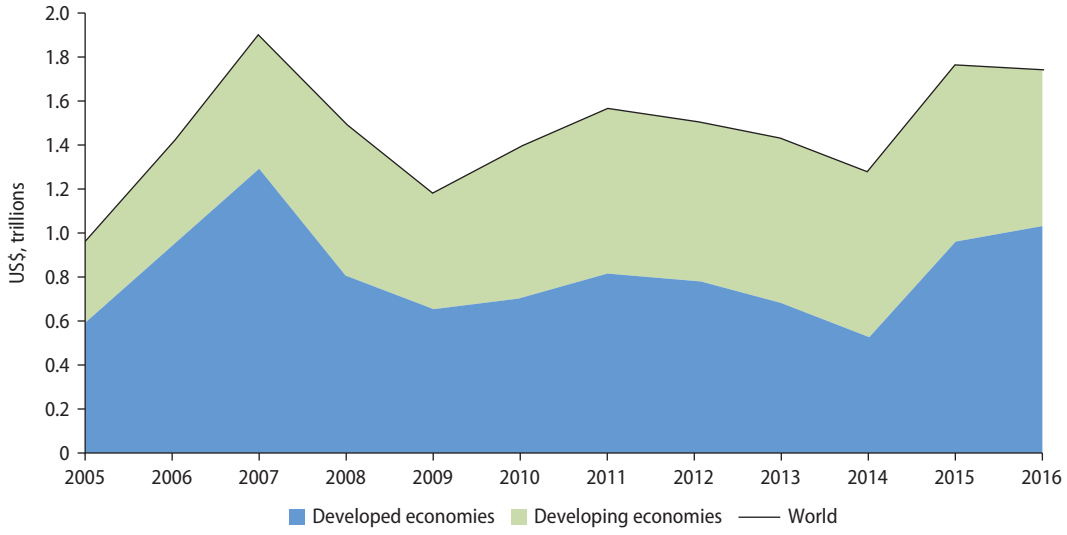
Foreign Investment Is a Major Contributor to Development

For many developing countries,[1] foreign direct investment (FDI) has become the largest source of external finance, surpassing official development assistance (ODA), remittances, or portfolio investment flows. In 2016, more than 40 percent of the nearly $1.75 trillion of global FDI flows was directed to developing countries, providing much-needed private capital (figure O.1). Yet the financing required to achieve the Sustainable Development Goals (SDGs)[2] remains prohibitively large and largely unmet by current FDI inflows—especially in fragile and conflict-affected situations (FCS) (map O.1). To maximize the development impact of FDI and thus help meet the SDGs, private investment will have to expand into areas where it has not yet ventured, notwithstanding the associated risks.

The benefits of FDI extend well beyond attracting needed capital. Foreign investment also confers technical know-how, managerial and organizational skills, and access to foreign markets. Furthermore, FDI has a significant potential to transform economies through innovation, enhancing productivity, and creating better-paying and more stable jobs in host countries, in sectors attracting FDI as well as in the supportive industries (Arnold, Javorcik, and Mattoo 2011; Bijsterbosch and Kolasa 2009; Echandi, Krajcovicova, and Qiang 2015; Rizvi and Nishat 2009; WEF 2013). Importantly, foreign investors are becoming increasingly prominent players in delivering global public goods, addressing climate change, improving labor conditions, setting global industry standards, and delivering infrastructure to local communities (IFC, forthcoming). This report builds on the literature in highlighting the role of FDI in upgrading growth and adding value to domestic firms, in filling the investment void in FCS, and more generally, in increasing competitiveness and stability.

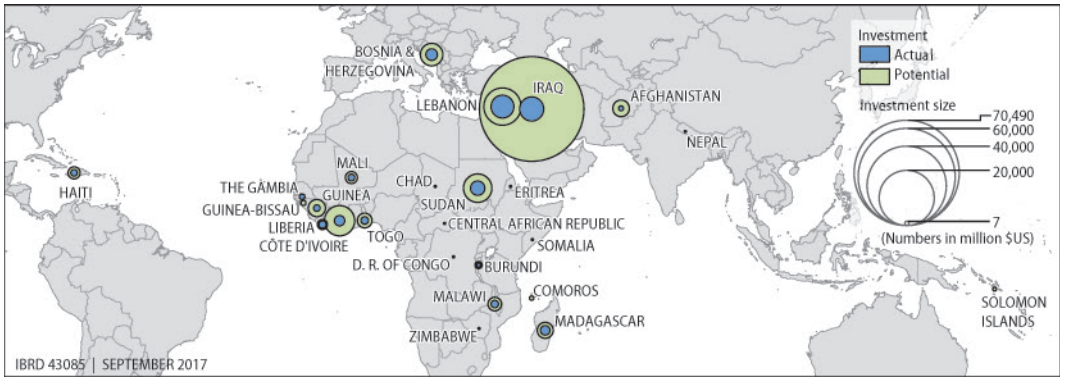
FDI can accelerate productivity gains in host countries. It brings foreign technology and frontier knowledge that, if successfully absorbed by local firms, can improve their productivity directly. FDI can also increase

FIGURE O.1 FDI Inflows, Global and by Development Group, 2005–16



Source: Statistics and World Investment Report 2017, United Nations Conference on Trade and Development (UNCTAD).
Note: FDI = foreign direct investment.

MAP O.1 FDI Flows to FCS Remain below Potential, 2008–Present



Source: Computation based on Investment Map Database, International Trade Centre; World Development Indicators, the World Bank; CEPII Database; Fragile States Index (2014), the Fund for Peace.
Note: Investment potential is calculated as foreign direct investment (FDI) inflow estimates without the negative effect of fragility. They are calculated for selected fragile and conflict-affected situations (FCS) based on countries' economic fundamentals (market size, growth, trade openness, savings), geographical remoteness, and abundance of natural resources, where the negative effect of fragility is removed.

competition among firms in the local market by leading to a reallocation of resources away from less productive to more productive firms, thereby increasing aggregate productivity over the long run. FDI can benefit domestic firms mainly through linkages and demonstration channels:

- *Linkages* between foreign firms and local partners or suppliers can promote transmission of foreign firms' technology, knowledge, and practices, as well as requirements that may help domestic suppliers upgrade their technical and quality standards (Du, Harrison, and Jefferson 2011; Farole and Winkler 2014; Javorcik and Spatareanu 2009). A recent study in Turkey suggests that interactions between multinational corporations (MNCs) and their Turkish suppliers

facilitate an upgrading of Turkish products (Javorcik, Lo Turco, and Maggioni 2017). Firm-level analyses from Lithuania and Vietnam present evidence that there are positive productivity spillovers from FDI through linkages between foreign affiliates and their local suppliers in the upstream sectors (Javorcik 2004; Newman and others 2015).

- The *demonstration effect*, in which domestic firms imitate foreign technologies and managerial practices either through observation or by hiring workers trained by foreign companies (Alfaro and Chen forthcoming; Alfaro and Rodriguez-Claire 2004; Alfaro and others 2006; Barba Navaretti and Venables 2004; Lipsey 2004), is another key channel benefitting firms in host countries. For example, the contribution of workers' mobility from MNCs to domestic firms in the Ghanaian manufacturing sectors has had a positive impact on the productivity of domestic enterprises. In Norway, workers with prior experience in MNCs contribute 20 to 25 percent more to productivity than workers without such experience (Balsvik 2006; Görg and Strobl 2005).

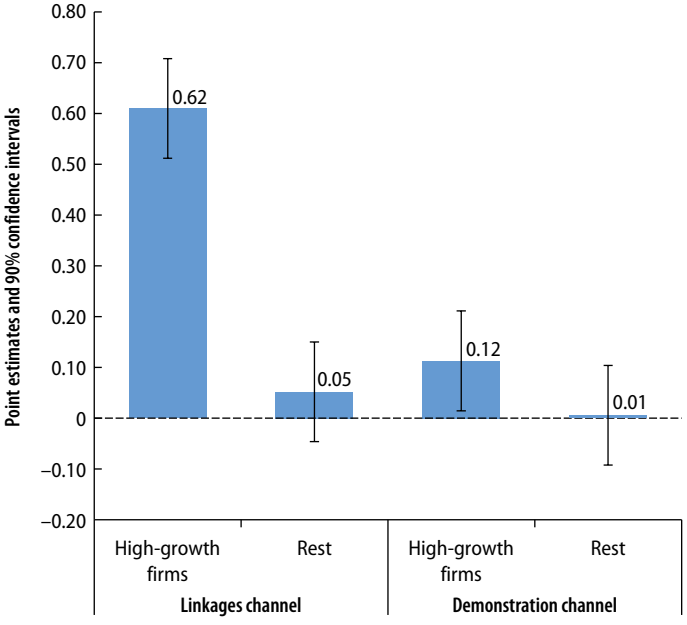
High-Growth Firms in Host Countries Benefit Most from FDI

This report analyzes the ability of domestic firms to benefit from the presence of MNCs, drawing on firm-level information across 50 manufacturing and services sectors and 121 economies in the developing world from the World Bank's Enterprise Surveys. It finds that local high-growth firms (defined as the subset of enterprises with the highest job creation rates) are most able to internalize FDI spillovers—through both linkages and demonstration channels. For the linkages channel, an increase of 1 percentage point in the share of inputs sourced domestically by foreign firms is correlated with a 0.6 unit rise in the measure of output growth of domestic high-growth firms. This result implies a 58 percent increase in sales over two years for the average high-growth firm. For the demonstration channel, an increase of 1 percentage point in the share of foreign output in the sector is correlated with a 0.1 unit gain in output growth of high-growth firms, or 12 percent increase in sales over the two years for the average high-growth firm (figure O.2).

While high-growth firms usually account for only a small part of the private sector, they have a disproportionately large role in job creation and productivity gains. They are better able to maximize the benefits from FDI because of their higher absorptive capacities—their ability to recognize the value of, assimilate, and apply new information. Such abilities allow these firms to internalize foreign technologies and processes to improve their productivity, thereby dampening the competitive impact of rivalry with foreign-established firms. Furthermore, the demands of global brands, and their

FIGURE O.2 High-Growth Firms Benefit from the Presence of Foreign Firms

Average impact of FDI spillovers on firm growth, by firm type



Source: Computation based on data from Enterprise Surveys, the World Bank.
Note: This figure shows the estimated coefficient and 90% confidence interval of the linkages and demonstration channels on high-growth firms and the rest of businesses in a sample of 121 economies. Vertical lines capture 90% confidence intervals. FDI = foreign direct investment.

commitment to their suppliers, create a strong incentive and impetus for suppliers to adopt new practices and invest in new technologies. From a policy perspective, identifying and targeting these firms, analyzing the constraints on their emergence, and deepening their absorptive capacities are all key to unleashing their full potential. The empirical evidence presented in this report indicates that policies that encourage FDI linkages as a way for high-potential indigenous firms to grow will enhance knowledge transmission between MNCs and domestic firms, and deliver strong development results.

Outward FDI Also Benefits Source Economies

FDI brings benefits not only to destination markets but also to source economies ("home country effects"). MNCs from developing countries use outward investment to strengthen their capabilities and competitiveness by entering new markets, importing intermediate inputs from foreign affiliates at lower prices, producing a larger volume of final goods and services abroad at lower cost, and accessing foreign technology (Herzer 2012). Some developing countries, instead of exploiting *existing* technological assets, aim to acquire *new* ones through outward FDI. Case studies of leading MNCs from BRICS countries (Brazil, the Russian Federation, India, China, and South Africa) show that they are disadvantaged in terms of patents, management know-how, or cutting-edge processes, which prompt them to acquire companies abroad to permit "late-comer catch-up" (Holtbrügge and Kreppel 2012; Rodriguez-Arango and Gonzalez-Perez 2016; UNCTAD 2005).

Outward FDI by developing countries can bring significant economic advantages back to source economies, especially enhanced innovation. While developed countries were once seen as the prime source of knowledge and technology—thus imparting a North–North or North–South bias to cross-border investment—a multipolar global technology network is now emerging, with growing South–South and South–North innovation-oriented interaction and collaboration (Nepelski and De Prato 2015). This may be partly because knowledge originating in developing countries may be better suited to other developing country settings, and because the level of complexity of that knowledge may be more easily absorbed by other economies at similar levels of development. This report highlights how the increased absorptive capacity of firms in source markets can promote a wide dispersion of outward FDI benefits in the home economy.

Despite abundant evidence on the development benefits of FDI, the global economic outlook remains uncertain, clouded by risks of trade and investment protectionism and geopolitical risk. While globalization brings aggregate productivity and economic growth, it may also bring hardship for low-productivity firms and low-skill workers. Slow public policy responses to rapidly evolving patterns of investment and economic activities contribute to misconceptions and oversimplification of features and potential effects of FDI. In certain countries, opponents of FDI-led integration further contend that its effects are often limited and, in some cases, detrimental—as it crowds out local competition, results in enclave production with limited linkages, and engenders a "race to the bottom" in labor or environment standards or in their enforcement.[3] Not surprisingly, policy discussions increasingly distinguish between "good" and "bad" FDI. Some argue that a foreign presence can lead to political grievances through its adverse effects on the distribution of income and opportunities, particularly concerning FDI in extractive industries (International Dialogue for Peace-Building and State-Building 2016). Others, however, find that trade and FDI complement each other in reducing the risk of conflict (Polachek and Sevastianova 2012). The truth is that there are different types of FDI, each with different potential social, economic, and environmental effects. Further, evidence shows that there is not

intrinsic "good" or "bad" FDI. Rather, there are good or bad policies that can or cannot lead countries to fully reap the potential benefits of FDI for development (Echandi, Krajcovicova, and Qiang 2015).

On balance, the bulk of the research and empirical evidence finds that FDI helps to foster development in recipient economies. Though some of the above criticisms are warranted and the distributional effects of the different types of FDI merit closer study, evidence for such claims is often anecdotal and applicable to only a narrow subset of industries and economies. As this report shows, the benefits of FDI can be strongly magnified in economies with good governance, well-functioning institutions, and transparent and predictable legal environments. Moreover, not all types of FDI nor all stages in the investment life cycle[4] exert the same effects on host countries. Some countries may attract FDI yet not enable its entry and establishment, or enable its establishment yet not its expansion and "rooting" in the host economy through linkages and other spillovers. These point to the need for a more nuanced analysis of FDI impacts.

Investment Decisions Are Influenced by Risk–Return Calculations

Investors consider a broad range of factors in their decision to invest, including domestic market size, macroeconomic stability and a favorable exchange rate, labor force talent and skills, and physical infrastructure. According to the *Global Investment Competitiveness* (GIC) survey (box O.1),

BOX 0.1

Global Investment Competitiveness Survey

The Global Investment Competitiveness (GIC) survey was commissioned by the World Bank Group as a companion piece of the GIC report to bring data and information on the views and behavior of global investors that goes beyond anecdotal evidence. Phone interviews were conducted between February and June 2017 with 754 international business executives involved with the operations of their multinational corporation in developing countries. Respondents come from both developed and developing countries and represent a wide range of sectors.

The GIC survey captures perceptions of these investors on the role of investment climate factors in guiding their FDI decisions. It complements other existing investor surveys by focusing on variables such as administrative and legal barriers rather than broader economy-wide factors. These specific investment climate variables are areas that are actionable for policy makers.

The survey is composed of four sections:

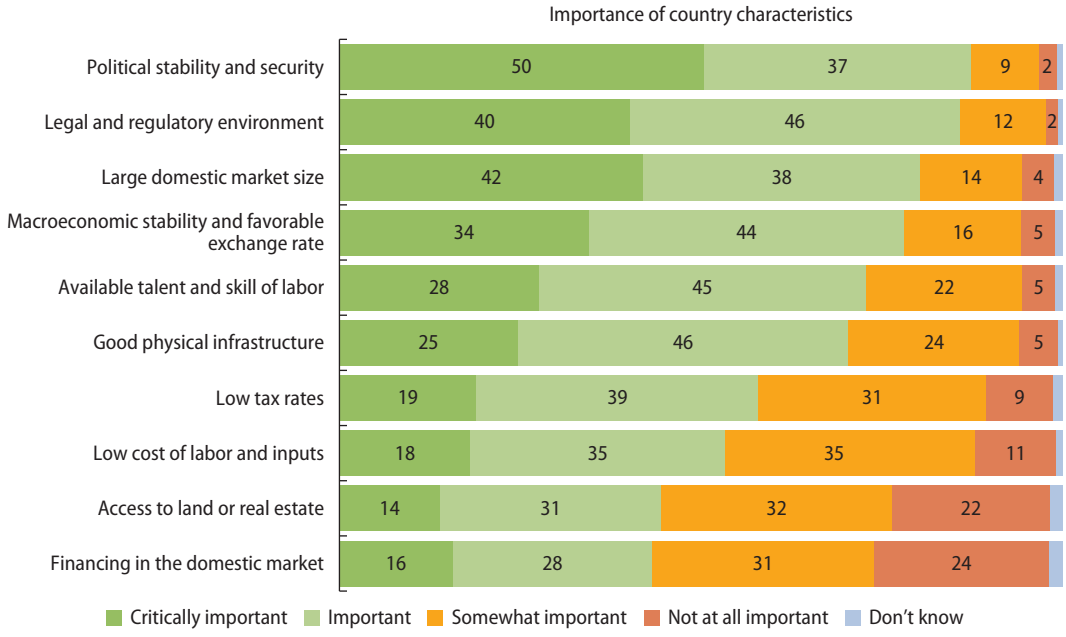
1. *General information on the company and respondent*, including sector, number of employees, and position of the respondent in the company.
2. *Importance of factors in investing in a developing country*, where respondents rate the importance of country characteristics and investment policy factors on a scale from 1 to 4 from "not at all important" to "critically important." "Critically important" means it is a deal-breaker—by itself, it could change the company's decision about whether to invest or not in a country.
3. *Political risks and investment exit*, where respondents identify experiences of political risks and the company's course of action. They were also asked about experience of shutting down a foreign affiliate in a developing country and their reasons for doing so.
4. *Investment in a specific developing country*, where respondents select a specific developing country where they are most familiar with the operations of the affiliate. Questions on the specific investment included sector, activity, motivation, reinvested earnings, efficiency of government agencies, availing services of investment promotion agencies, incentives received, sources of inputs, and corporate programs for suppliers.

political stability and a business-friendly regulatory environment are most important in investors' decision making (figure O.3). Macroeconomic, political, and regulatory risks—whether actual or perceived—deter investors by raising their risk calculations. De-risking, or reducing project or country risk, can lead to the right risk–return profile and help attract private investment. Otherwise investments that are commercially profitable and economically attractive may simply not materialize.

Governments in both developing and developed countries use tax and other investment incentives to reduce the relative cost or risks to foreign investment so as to attract more FDI, often not distinguishing among the different types of FDI.[5] Given that most countries offer incentives, investment promotion agencies face pressure to match or even surpass offers by competing countries to compensate for adverse geography, small size, or distance to markets, in order to remain attractive for foreign investors.

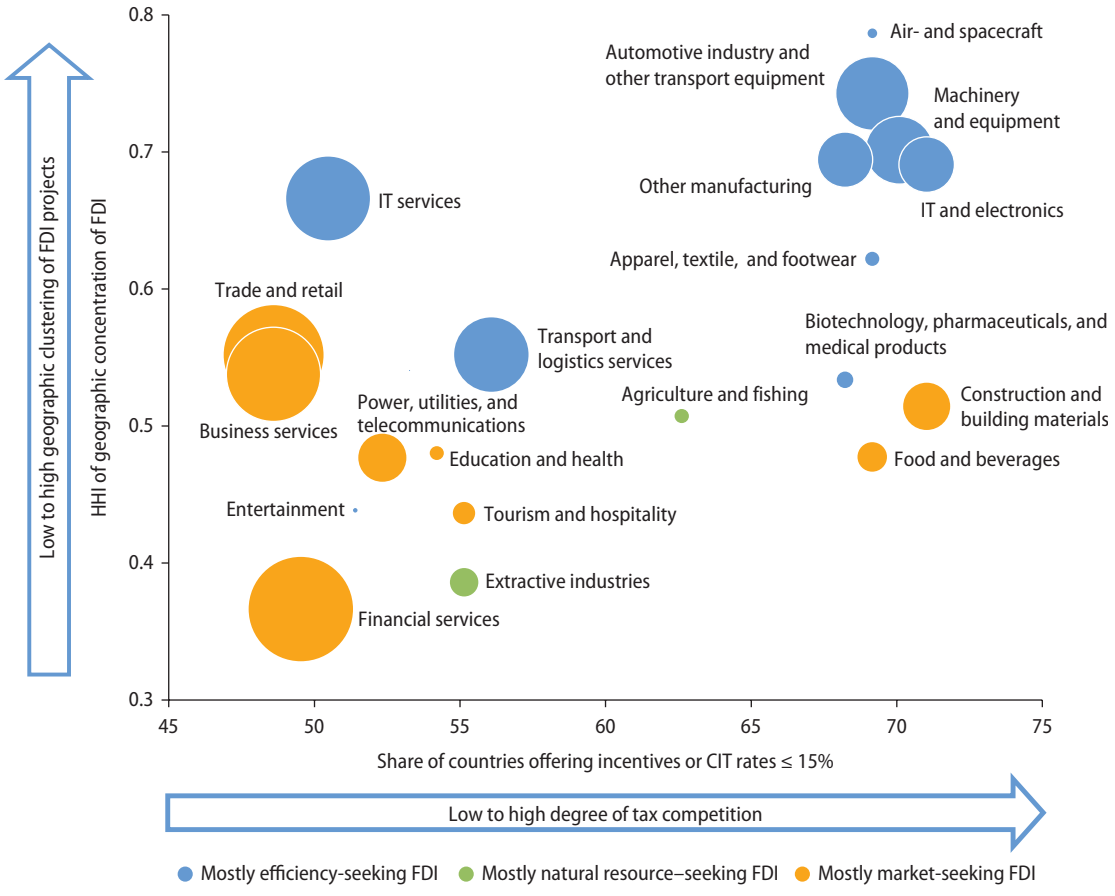
Yet investment incentives become relevant only when investors waver between similar locations. Where FDI is motivated by access to domestic markets or natural resources, incentives are generally of limited value. However, in sectors where FDI is mainly efficiency-seeking in nature (for example, manufacturing of information technology [IT] and electronics, machinery and equipment, automotive, air- and spacecraft, and biotechnology and pharmaceuticals), competition for FDI is high and developing countries frequently offer incentives to compete. In these sectors, most FDI projects are clustered in a limited number of successful host countries. At the same time, the use of incentives is particularly prevalent in these sectors (figure O.4, upper right quadrant). This suggests that developing countries use incentives strategically in sectors with high shares of efficiency-seeking FDI where locational competition for FDI is particularly intense. It also reveals that, while incentives may be a more important part of the value proposition to efficiency-seeking investors,

FIGURE O.3 Factors Affecting Investment Decisions
Share of respondents (percent)



Source: Computation based on the GIC Survey.
Note: Multinational corporation executives were asked how important these characteristics were in their decision to invest in developing countries.

FIGURE O.4 Prevalence of Incentives and FDI Concentration
(Incentives are used most in sectors with high competition for efficiency-seeking FDI)



Source: Developing Country Tax Incentives database and FDI data from fDi Markets database, the Financial Times.
Note: The size of each bubble represents the number of FDI projects within the sector in developing countries. This was constructed based on information from the fDi Markets database. CIT = corporate income tax; FDI = foreign direct investment; HHI = Herfindahl-Hirschman Index; IT = information technology.

they are not a sufficient condition for FDI entry, as efficiency-seeking FDI tends to concentrate geographically in relatively few locations despite the broad availability of incentives.

More targeted, transparent, and cost-effective use of investment incentives can improve their impact. By targeting incentives toward those investors most likely to respond to them, developing countries can reduce unnecessary tax losses resulting from incentives granted to firms that would have invested anyway. This requires a thorough understanding of the type and motivation for FDI in the country, as well as measurable policy objectives. At the same time, improvements in the design, transparency, and administration of incentives can help reduce indirect costs and unintended consequences including economic distortions, red tape, and corruption. Such policy reforms can greatly improve the cost–benefit ratio of incentives.

Governments Play a Key Role in De-Risking Private Investment

Reducing the risks of private investment at the project level does not compensate for failing to de-risk regulations and institutions

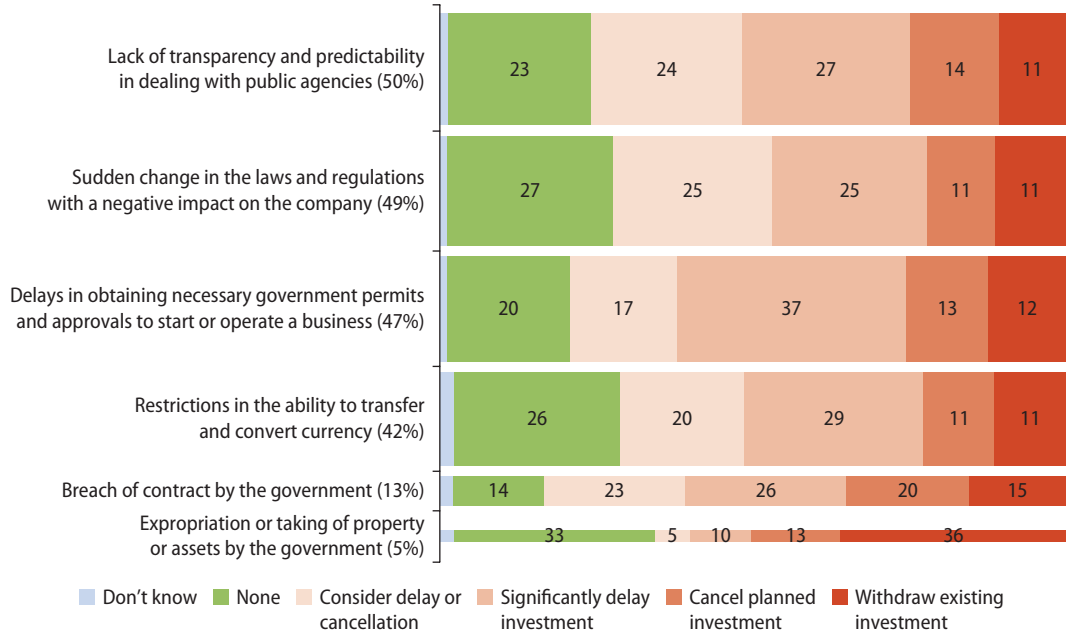
at the country level. Investment incentives or investment guarantees are frequently used to bolster locational competitiveness or investment viability for specific projects or sectors, but investment climate weaknesses must be addressed first. If fundamental elements at the country level are lacking, investors are unlikely to respond to even the most generous incentive packages or such incentives may only attract unviable investments. Governments can reduce risks to private investors through a policy and institutional framework that supports an enabling business climate and ensures good governance. Since reliable regulations and institutions are key to de-risking private investment at the country level, they are an increasingly important element on the Maximizing Finance for Development agenda.

In this report, de-risking involves removing or reducing political and regulatory risks caused by government action, building on macroeconomic stability and good infrastructure in order to attract private investment. Political risks are wide-ranging and include expropriation, transfer and convertibility restrictions, breach of contracts, unpredictable and arbitrary actions, discrimination, and the absence of regulatory transparency. Loss of investment and the associated damage to long-term harmonious relations with a promising investor can have a debilitating impact on a developing country. Political risk related to government conduct also sends negative signals to prospective investors, creating strong ripple effects.

More than three-quarters of investors surveyed in this report encountered some type of political risk in their investment projects in developing countries. In severe cases, such as expropriation, about half of the investors canceled a planned investment or withdrew an existing one (figure O.5). Legal protection to investors against such risk is usually provided by "investor protection guarantees" typically included in a country's domestic legal framework and its international investment agreements (IIAs). In this report's survey, 81 percent

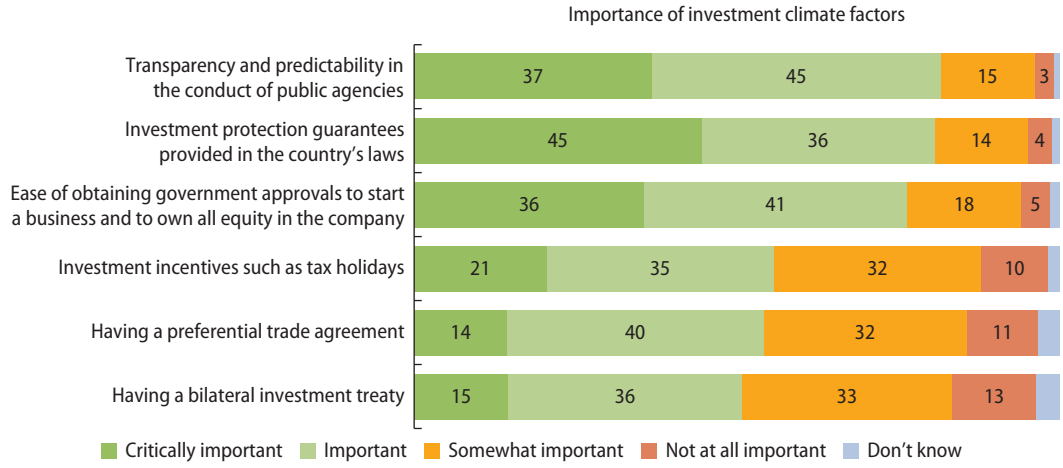
FIGURE O.5 Political Risks Are Prevalent and Discourage FDI

Share of respondents (percent)



Source: Computation based on the GIC Survey.
Note: FDI = foreign direct investment.

FIGURE O.6 Regulatory Predictability and Efficiency Are Critical
Share of respondents (percent)



Source: Computation based on the GIC Survey

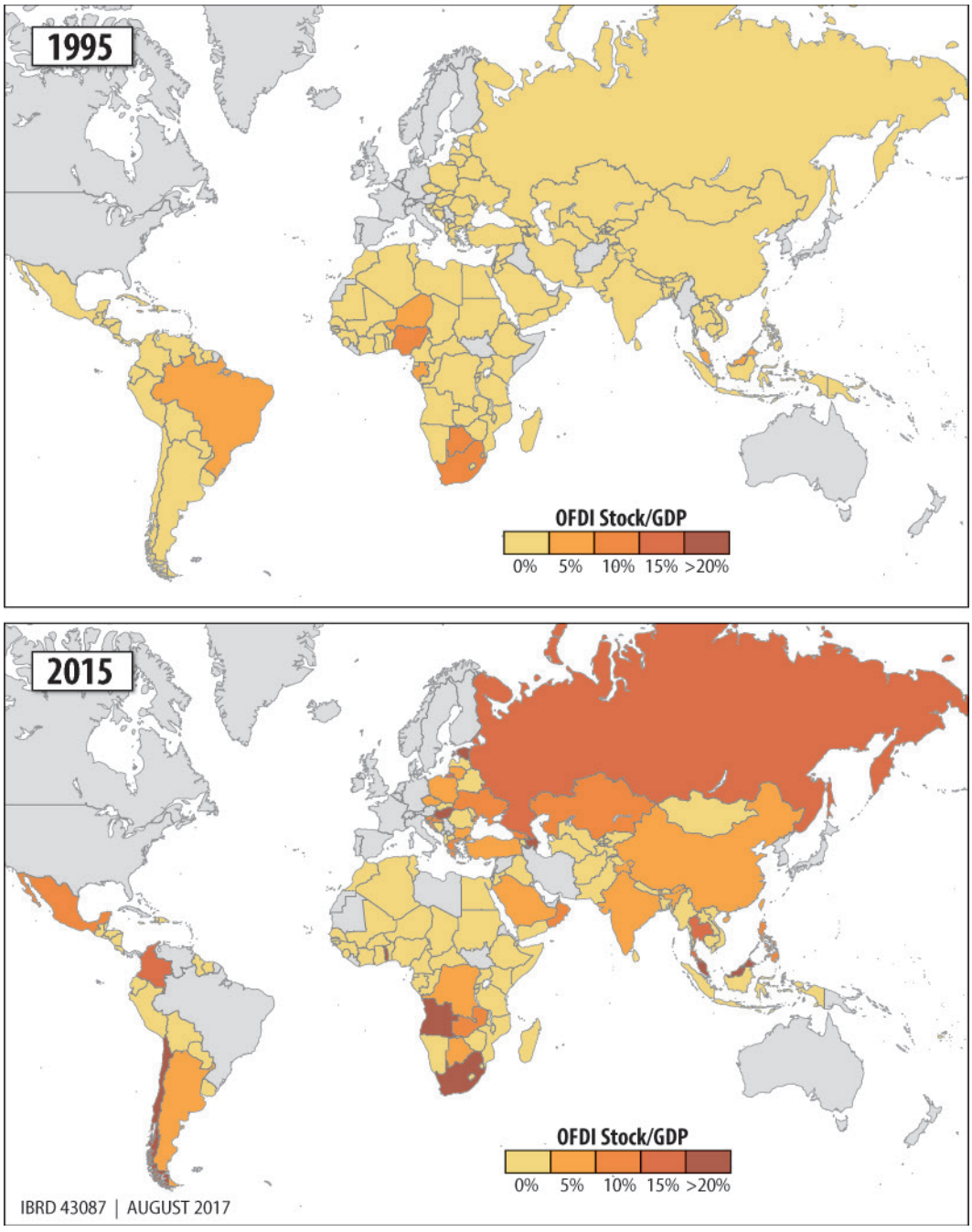
of investors rate country legal protections and 51 percent rate bilateral investment treaties as important or critically important in their investment decisions (figure O.6). Such findings echo the literature documenting the generally positive impacts of IIAs on FDI inflows (Echandi, Krajcovicova, and Qiang 2015).

Investors also seek predictability and efficiency in the implementation of laws and regulations (figure O.6). About four out of five investors surveyed rate the transparency and predictability of public agency conduct—and the ease of doing business—as important determinants of their locational decisions. This is not surprising, since many developing countries have inefficient bureaucracies, opaque regulations, complex procedures, and high transaction costs—all of which can undermine their competitiveness. More than one-third of investors rate these as critically important factors or potential deal-breakers. Predictability and efficiency are essential ingredients of sound and sustained interaction between MNCs and host governments, comprising both regulations themselves and their implementation.

Developing Country MNCs Are Today an Increasing Source of FDI

FDI from developing countries has increased twentyfold in the last two decades, accounting for nearly one-fifth of global FDI flows in 2015. As such, contribution of Southern MNCs to economic development of emerging markets is significant, especially given low investor confidence prevailing today among traditional Northern MNCs. Despite a fall in FDI from Organisation for Economic Co-operation and Development (OECD) countries by 57 percent below 2007 levels in 2012, FDI from developing countries rose by 19 percent (OECD 2014). While larger developing countries, especially the BRICS, are driving this phenomenon, about 90 percent of developing countries of all sizes and income levels are now undertaking outward foreign direct investment (OFDI) (map O.2). Both domestic policy choices in developing countries and global economic conditions have shaped changes in the investment landscape. Firms in Singapore and other high-growth economies embraced OFDI in the

MAP O.2 Growth of OFDI in Most Developing Countries



Source: UNCTAD and World Development Indicators, World Bank.
Note: GDP = gross domestic product; OFDI = outward foreign direct investment.

late 1990s and early 2000s as a development strategy to "achieve efficiency in resource allocation and diversify risks from economic shocks in any one region" (Lee, Lee, and Yeo 2016).

Firms in other developing economies soon emulated such efforts, with OFDI increasingly seen as a means to access markets, capital, technology, and knowledge in international markets—and thus boost firm-level and national competitiveness (Luo, Xu, and Han 2010). Global economic conditions also "pulled" developing-market firms into OFDI. First, rapid and sustained growth in much of the developing world during the last two decades helped firms to grow and prosper and, consequently, to internationalize. Second, the commodity super-cycle (until recently) gave some developing country exporters large windfalls, creating substantial liquidity that was used partly to finance OFDI.

The emergence of developing countries as a key source of FDI begs the question of whether they differ from developed countries in terms of the drivers and risk tolerance of their OFDI. Both the report's investor survey and data analysis suggest that developing country OFDI reacts to standard host economy locational determinants (for example, market size, income level, distance, common language, colonial links) in much the same way as developed country OFDI. Both are attracted to large and growing economies that are geographically close and culturally similar.

Developing country investors are more willing to target smaller and closer economies (Arita 2013) in a "stepping-stone" strategy. Evidence suggests that some of these firms find it difficult to compete in larger, more competitive, and more distant markets, not least because they often lack the networks and experience of developed country firms. Studies from Asia and Latin America find that regional investors usually expand into larger and more complex markets only after first successfully expanding in smaller, lower-income economies in the same region (Cuervo-Cazurra 2008; Gao 2005).

Developing Country and Regional Investors Target Higher-Risk Markets

Developing country investors may also be more willing to target higher-risk markets in host economies with weaker institutional quality.[6] In 2001, only 11 countries in the developing world (5 in Sub-Saharan Africa, 5 in Europe and Central Asia, and 1 in Latin America and the Caribbean) had half or more of their inward FDI stock coming from investors from other developing countries. In 2012, that number had risen to 55 countries. Developing countries are a particularly key source of FDI for countries in Sub-Saharan Africa, Europe and Central Asia, and South Asia. With many of these host economies characterized by low levels of economic development, such trends accord with the literature, which finds developing country OFDI to be less discouraged by weak institutional and economic host-country environments (Cuervo-Cazurra 2008; Dollar 2016; Ma and Assche 2011) owing to the "institutional advantage" argument (Cuervo-Cazurra and Genc 2008). This argument suggests that managers of developing country MNCs are more accustomed to uncertainty and may be more adept in dealing with unpredictable regulatory practices and less transparent administrative procedures. Several studies support this argument, finding that developing country OFDI investors are relatively more present in least developed countries. Some demonstrate an inverse relationship between host country political risk and, for example, Chinese OFDI (Cui and Jiang 2009; Duanmu and Guney 2009; Kang and Jiang 2012; Quer, Claver, and Rienda 2015).

Risks in FCS range from security and value-chain disruptions to regulatory, financial, and reputational uncertainty, all of which make foreign investors reluctant to engage. In many cases, governments lack the capacity and revenue base to perform basic functions. Often, informal and noninclusive institutions fill the governance vacuum, and

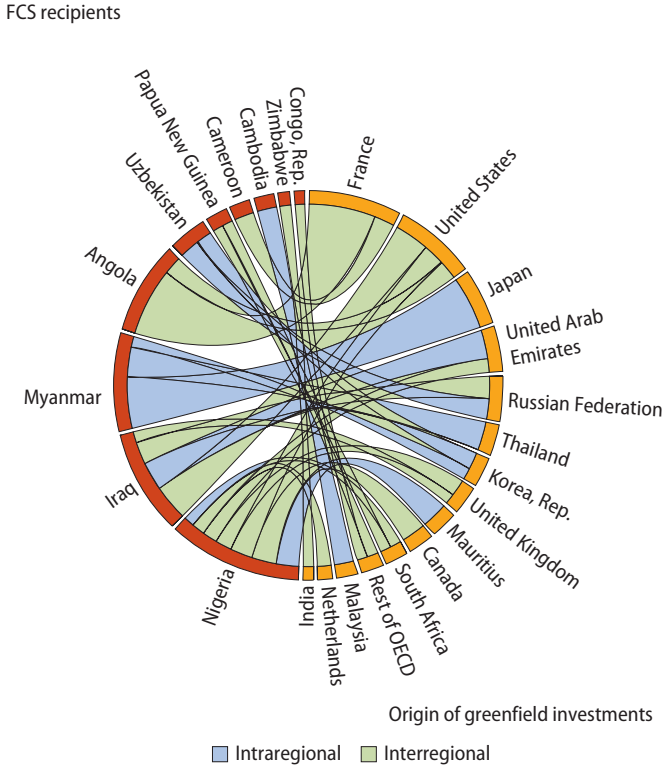
institutions fill the governance vacuum, and their interaction with businesses is frequently motivated by rent-extraction. Firms also face an array of adverse market conditions similar to those in other low-income countries, such as weak macroeconomic and regulatory environments, infrastructure bottlenecks, and a limited supply of skilled labor, compounded by low demand. However, unlike in many developing countries, the destruction of physical and human capital and diminished state control result in highly risky business environments. As a result, FDI in FCS represents a mere 1 percent of global flows, more than five times lower than the world average. Despite having increased tenfold over the last two decades, the distribution of FDI directed to FCS is still mostly concentrated in a handful of middle-income or resource-rich economies. Such FDI targets a handful of sectors, all of which are capital intensive and sustained mostly by foreign demand. Investors are more cautious when they enter FCS markets: they tend to commit to smaller projects that produce fewer jobs for every dollar invested and tend to concentrate their investment spatially in the most stable regions or cities in FCS.

Regional investors may have a comparative advantage in FCS contexts relative to global firms. A considerable amount of greenfield investment in FCS comes from regional firms (figure O.7). The investment footprint of France and the United Kingdom remains large in Africa and the Middle East, but greenfield investments (for example, from Russia to Uzbekistan, Malaysia to Cambodia, South Africa to Nigeria, Japan and Thailand to Myanmar, and the United Arab Emirates to Iraq) confirm that intraregional investment takes place in FCS on a large scale. Other regional investors include, for example, companies from Lebanon investing in neighboring Middle Eastern countries, companies from Morocco expanding into markets in North Africa, and Nigerian firms expanding into West Africa. These firms leverage their superior knowledge of the local context and their affinity with their target markets. As a result, such investors show greater resilience, take more risks (for example, committing to larger projects), and accept lower returns. This trend highlights once more the importance of regional sources of investment, and of regional integration schemes, in transitioning out of fragility.

First movers willing to make pioneer investments in challenging environments in FCS are critical for signaling the viability of business opportunities in these markets. MNCs operating in FCS often make strategic choices in terms of scale, staffing, and location that seek to address multiple challenges and risks simultaneously. Some of the response strategies documented by interviews with investors (IFC 2017) include integrated management and due diligence systems; strategically locating warehouses and production

FIGURE O.7 Regional Investment Occurs on a Large Scale

Origins of greenfield FDI project announcements in FCS (2008–16)



Source: Computation based on fDi Markets database, Financial Times.
Note: Origins (on the right side of the chord diagram, in orange) and FCS destinations (on the left side, in red) of greenfield projects exceeding US$3 billion since 2008. Blue chords indicate intraregional investment. FCS = fragile and conflict-affected situations; FDI = foreign direct investment; OECD = Organisation for Economic Co=operation and Development.

sites; staged investments; striving to meet international standards; and flexibility in scale, supply, and business plans. Pioneering investments can help host-country governments develop regulations and support services, establish business and consumer markets, and generate positive externalities. They also offer a demonstration effect to other investors that the target countries and markets are open to financially viable investments despite high risk perceptions.

Investment Climate Reforms Reduce Uncertainty and Unpredictability

Investment climate reforms are necessary for markets to move from conflict to peace and from fragility to resilience. Firm-level responses are limited in what they can achieve—investors may strive to keep their companies out of harm's way, but they can only go so far in coping with them and cannot address these risks in a holistic and systemic way. Investment climate reforms tailored to the context of FCS, however, can go a long way toward reducing investors' risks and creating markets for viable investment. The limited capacity of many governments in FCS, combined with the urgency of positive returns on reform efforts, require the proper sequencing and prioritization of interventions. An investment climate engagement must be implemented in a balanced way by securing short-term gains while building the momentum for deeper institutional transformation over the longer term.

Regulatory simplification, removing barriers to investment entry, and addressing infrastructure constraints (for example, access to electricity and transit) rank among the most important confidence-building signals that can produce early results and trigger a private sector response. Value chain development through skills building, access to finance and technology, and connecting producers to markets can be second-stage interventions suitable for FCS (World Bank Group 2011). Deeper institutional reforms may take longer to occur—it took the fastest-reforming countries in the 20th century two decades to achieve a functioning governance quality—and the scope and speed of reforms are themselves risk factors (World Bank Group 2011). But strengthening public institutions that provide citizens with security, justice, and jobs is crucial to breaking the cycle of violence.

The rest of this report is organized around five thematic chapters, each exploring a different dimension of FDI in developing countries:

The discussion of the findings from the GIC survey (chapter 1) aims to help policy makers design policies and prioritize reforms valued by foreign investors. Through some 750 interviews of executives of MNCs with investments in developing countries, the survey measures the role of investment climate variables (for example, investment incentives, investment promotion activities, FDI regulations, and administrative processes) in influencing FDI decisions. By identifying factors that are important to investors, reform-minded governments can leverage policy instruments that can most effectively attract, retain, and leverage FDI for development. Recognizing resource constraints faced by most governments, the authors of this chapter suggest where policy makers can focus their efforts to maximize impact.

FDI in developing countries benefits local high-growth firms the most (chapter 2). This is due likely to their higher absorptive capacity—that is, their ability to recognize the value of, assimilate, and apply new information to improve production processes. High-growth firms account for a sizable share of job creation and productivity gains in developing countries. The distinctive characteristics of these firms have been the subject of study from the perspective of both individual firms interested in sales and revenue growth and policy makers interested in job creation and economic growth. The findings discussed in this chapter have strong implications for programs aimed at facilitating the connection

of domestic firms to established MNCs through government-supported linkage programs.

Tax incentives play a role in FDI in developing countries (chapter 3), and the authors of this chapter offer practical evidence to help developing country policy makers design and implement more effective incentives. Using a new dataset on tax incentives in developing countries compiled by the World Bank Group, the authors provide sector- and firm-level evidence to guide policy makers on how to target investment incentives more efficiently. The analysis assesses how developing countries use tax incentives by sector and over time, links the effectiveness of incentives to a simple framework of investor motivation to guide policy makers in these targeting questions, and presents new evidence on the relevance of tax incentives for investors. Tax incentives are found to be commonly used by developing countries, with some variation across sectors and regions, and tend to be more effective in attracting efficiency-seeking FDI. The authors also identify priorities for the design, transparency, and administration of incentive reforms.

Developing country OFDI has increased considerably in recent years (chapter 4), and the authors of this chapter explore its main drivers and offer policy proposals to maximize its development impact. They use several global data sources to assess changes over time in the investment patterns of developing country MNCs, particularly with regard to source and destination economies, target sectors, and modes of entry. The authors complement this information with findings from a gravity model to explain the influence on developing country OFDI behavior of several FDI location determinants, such as relative market size, geographical distance, common cultural and institutional features, and the existence of bilateral investment agreements. They also consider whether OFDI can foster the development of source economies and review the relevant literature. They offer evidence that OFDI increases home firm innovation and exports, but the literature on other aggregate benefits—such as productivity, domestic investment, employment, and economic growth—is still nascent.

The discussion of FDI in fragile and conflict-affected situations (chapter 5) fills a gap in understanding the potential, patterns, and constraints of FDI in such states and explores ways to support investments that have a positive effect on peace and stability. The authors draw on original data and analysis of investment in high-risk environments to explain investment decision-making and coping mechanisms in such contexts. They propose an approach to investment climate reforms that aims at securing short-term gains while building the momentum for deep institutional transformation. Key elements of that strategy focus on reducing risks to investors as well as maximizing investment opportunities and rewards.

Notes

1. "Developing countries" in this report refer to low- and middle-income countries as defined by the World Bank. The full list of countries appears in the glossary. The list is based on income categories in fiscal year 2017 at http://databank.worldbank.org/data/download/site-content/OGHIST.xls.
2. The 17 SDGs of the 2030 Agenda for Sustainable Development were adopted by world leaders at a United Nations summit in September 2015 and are listed in http://www.un.org/sustainabledevelopment/sustainable-development-goals/.
3. According to work by Theodore Moran (2014), the evidence actually indicates that the entry of foreigners and their first-tier suppliers introduces "*Schumpeterian winds of creative destruction*" that may lead to beneficial restructuring of the entire industry, including opportunities for better-performing local companies in the same industry, and for suppliers in the vertical industries to emerge over time. Moran notes that the outcome to observe is the changing economic performance of the entire sector, as opposed to arbitrary measurement of the absolute amount of capital invested at any particular moment in the sector (as is often highlighted in the debates on crowding-in and crowding-out). The Czech Republic is a good

example of how acquisition of a dilapidated local carmaker Skoda by Volkswagen, one of the leading global firms, led to a successful transformation of the entire automotive industry in the country.

4. The FDI life cycle considers the relationship among foreign and domestic investors, governments, and civil society in various stages of investment. Based on the FDI vision and objectives of the host economy, the cycle begins with attraction of FDI into a country. It then moves into enabling investors to enter and establish presence in the domestic economy. Once operational, FDI is encouraged to stay in the long term, leading to expansion and "rooting" the FDI into the domestic economy through linkages and other spillover effects with the domestic private sector.
5. Other ways that help to de-risk private investment projects include blending grants or concessional funds with private finance to improve risk–return ratios; guarantees to, for example, large infrastructure projects to cover key noncommercial risks or sharing risks; partial credit guarantees that enhance the terms of commercial debt by extending maturity, lowering interest rates, or enabling access to financial markets.
6. The World Bank's World Governance Indicators (WGI) decompose institutional quality into six dimensions: Voice and Accountability; Political Stability and Absence of Violence; Government Effectiveness; Regulatory Quality; Rule of Law; and Control of Corruption. See http://info.worldbank.org/governance/wgi/#home.

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