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DIFFERENT ARGUMENTS FOR AND AGAINST THE ROLE AND IMPACT OF FOREIGN INVESTMENT ON THE DEVELOPMENT POTENTIALS OF DEVELOPING COUNTRIES: AN OVERVIEW

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ABSTRACT

This study explores different arguments for and against the role of foreign investment on the development potentials of developing countries. Generally, foreign investment comes to host countries through transnational corporatios (TNCs). These corporations are global profit-seeking organisations, investing in more than one country and supplying financial capital, management, technology and marketing enterprise. The arguments for and against the role and impact of foreign investment focus mainly on the following areas: economic growth, technology transfer, balance of payments, export performance, employment, environment, and transfer pricing as well as socio-cultural aspects of TNCs. The study concludes that with the appropriate government policies, such as unbiased trade regime, market reform and cooperation, developing countries could provide more benefits from foreign investment.

1. Introduction

The role and impact of foreign investment on development potentials of developing countries (hereafter LDCs) are a debatable subject. It may enhance economic growth and development process of developing countries, but at the same time it provides a direct control to the owners of assets on activities in the host country. This study examines this controversial issue and the efficacy of these contrary arguments. The plan of the study is : Section two explores the relationship between TNCs and foreign investment, section three looks into the role and impact of foreign investment critically on the various aspects of LDCs' development potentials and the last section concludes the study with some explanations.

2. Transnational Corporations and Foreign Investment

The most common manifestation of foreign investment (FI) is through transnational corporations (TNCs). TNCs are global profit-seeking organisations which have their own objectives and strategies, and the political support of the advanced countries. Their main objective is to maximise their return on capital. For this purpose, they seek out the best profit opportunities in a wide range of activities in host countries and they deal rarely with issues, such as poverty, inequality, and unemployment alleviation. TNCs may be defined as "firms investing in more than one country and supplying more than financial capital; for example management, technology or marketing expertise"

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(Weiss 1991:77). They usually come in host country with a package, including capital, technology, management and marketing skills. They, thus, can improve competition, efficiency, provide additional jobs, and help the income distribution improvement. TNCs have generally world leadership in innovation and product differentiation; they can access directly and easily to the world's largest markets; and have the managerial, entrepreneurial and financial resources to develop viable production bases in LDCs (Vernon 1977; Lall 1985). They operate within oligopolistic market structures and are characterised by rapid product process, innovations, product differentiation and heavy advertisement. TNCs have ability to view the world as a single economic unit and consequently to plan, manage and organise their operations on a global scale. In recent years, foreign direct investment (FDI)[1] and Foreign portfolio investments[2] to LDCs have risen sharply. For example, while the average annual net inflow of FDI to LDCs was US$ 11 billion during 1980-1986 period, it reached to US$ 35 billion in 1991 and US$ 43 billion in 1992 (World Bank 1995). FDI was heavily dominated in 1950s and 1960s by American-based enterprises world wide. It continued to expand in 1970s. "The rapid increase in FDI throughout the world has been accomplished by a pronounced change in its sectoral composition, from the primary sector and resource-based manufacturing towards services and technology-intensive manufacturing" (WIR 1993: 3). But its sectoral composition has changed considerably. The primary and extractive sectors in 1950s and 1960s were attractive areas for FI, but in the 1970s there was a shift towards manufacturing and services sector (Todaro 1989; Weiss 1991; Todaro 1994). Capital-intensive manufacturing branches, such as chemicals, machinery, electrical goods and transport equipment, are attractive areas for TNCs. Petroleum and gas took dominant share of TNCs' world sales (24.6 %) in 1989. But they were

[1] Foreign direct investment may be defined as 'the investment that is made to acquire a lasting management interest (usually of 10 % voting stock) in an enterprise operating in a country other than that of investor (defined according to residency), the investor's purpose being an effective voice in the management of the enterprise' (World Debt Tables 1993-1994: xiv).

[2] Foreign portfolio investment involves the acquisition of foreign securities by individuals or institutions without any control over or participation in the management of the companies concerned (see Hood and Young 1979: 9).

followed by machinery and equipment with a share of 24.5 % machinery and equipment, chemicals 13.5 %, motor vehicles 12.6 %, etc. (see WIR 1993).

3. The Role and Impact of Foreign Investment in LDCs

LDCs need to pursue their developmental policies aiming at promoting economic growth and improving the quality of life, while at the same time closing the gaps with developed countries. It is argued that FI can help LDCs in filling the gaps between the targeted and desired investment, foreign exchange constraint, government revenue-expenditure, skills, technology and enterpreneurship which inhibit developing countries' thrust for economic growth (Todaro 1989; 1994). Filling these gaps has a vital importance for LDCs to speed up their economic development. This is so because TNCs possess a 'package' of attributes which coincide with the gaps constraining LDCs' economic development. A marriage between LDCs and TNCs therefore seems logical and FI is seen in LDCs as a source of exchange earning; a supplement to low levels of domestic savings to finance investment; a tool of encouraging exports; and as a means of technology transfer.

In Central and South American countries, the net value of foreign capital influx to these countries in 1994 was 56.6 $ billion, which was equivalent to 5 % of the GDP of total region (see Jetro White Paper 1995). A steady influx of foreign capital during the first half of 1990s facilitated an economic recovery and sustained steady growth in Central and South America by compensating for a shortage in domestic savings and investment and by stimulating production.

In low income developing countries the role of FI in promoting economic development is said to be more vital. In Somalia, for instance, FDI inflow was over 20$ million in 1984 which equal 7.5 % of gross domestic investment of Somalia (see TNCs in World Development 1988). Perhaps the most attractive feature of FI through TNCs is that it provides skilled management and technology, well organised production processes based on economies of scale and ready-made marketing outlays for established brands for LDCs.

The basic arguments for and against the developmental impact of foreign investment in LDCs may be evaluated in the following areas:

3.1. Foreign Investment and Economic Growth

Undoubtfuly, one of the important gaps to be filled for an LDC is the saving-investment gap. This gap is explained within the context of Nurkse's vicious cycle hypothesis[3]. In this view FI is essential to break this vicious cycle

[3] The vicious cycle hypothesis argues that low savings lead to low investment, which in turn limits capital formation. This , consequently, leads to low labour productivity and incomes and finally back to low savings.

to unleash the development potential of LDCs by allowing the savings of investors from the developed countries to augment the low savings in the LDCs in the quest for development.

The Harrod-Domar growth model postulates that there is a direct relationship between a country's saving rate and its rate of growth. It is argued therefore that FI, particularly FDI, could contribute to the economic growth and development process of LDCs by filling the saving-investment gap through various channels, such as transfer of modern technology, management skills, human capital development and exporting market access.

In Singapore, for instance, FDI has made very important contribution in filling the gap between domestic savings and investment. While the share of gross domestic savings was equal to -3 % of GDP in 1960, it increased to 20 % of GDP in 1970 and 33 % of GDP in 1981 (see Lecraw 1985). With the contribution of FDI, the share of investment reached 42 % of GDP in 1981 which was the highest rate in the world.

Similarly, in China in the early 1970s the share of FDI in China's total fixed asset investment was very small. But it increased rapidly in the following years with the introduction of open door policy in 1978 (see Chen *et al*. 1995) . In 1982, the actual contribution of FDI to China's GDP and total fixed asset investment (TFAI) was 0.04 % and 0.68 % respectively. However, throughout following years the share of FDI in China's GDP and TFAI has showed an increasingly increasing trend. In 1990, the contribution of FDI to China's GDP and TFAI reached nearly 1 % and 3.6 % respectively.

Portfolio investment flows have also great potential for direct impact on economic growth of LDCs. Due to the increasing attractiveness of yields in emerging markets, portfolio investments have become the faster growing component of foreign equity flows to LDCs. However, in the long-run there may be a net outflow, which results the transfer of profits, royalty payments, licence fees, etc., and thus FI could have a negative impact on growth rates of host country (Todaro 1989; Weiss 1991).

3.2. TNCs and Transfer of Technology

In LDCs TNCs are seen as one of the major sources of technology generation and dissemination. They play important and effective role in the process of technology transfer to LDCs by providing investment, by supplying capital goods or by providing unpackaged technology particularly through licensing. In China, for instance, FDI has made significant contribution to the transfer of software managerial and export marketing technology. The transfer of technology has been provided in low, intermediate and even high technology areas through establishment of manufacturing facilities, training, and learning

by doing (Chen *et al.* 1995).

However, it is argued that TNCs may perpetuate technological dependence by transferring costly, inappropriate and capital-intensive technology to LDCs and the reaction of TNCs to the development of an indigenous Research and Development (R&D) expenditure is almost negative. In most LDCs native technological capacity is not an alternative to the successful transfer of technology. The factors such as substantial inflows of foreign technology, a rapid development of native technologies abilities, and investment in education and training, could help successful accumulation of technology.

3.3. Foreign Investment and Balance of Payments

Foreign investment has a major impact on the balance of payments (BOP) of host countries. The effect of FI on the BOP of host countries can be direct and indirect. The direct effects include imports of funds and exports as benefits; imports of capital goods and raw materials, exports of profits, and interest and technological payments as costs. Indirect effects of FI cover the final BOP impact of local sales and the use of local capital.

However, FDI in an economy with highly distorted policies is likely to generate net losses for the host country rather than welfare gains. A study done by Lall (1978) showed that the net direct BOP effects of FDI in selected LDCs, with the exemption of specifically export-oriented ones, were negative. About 91 % of 159 foreign firms affected the BOP negatively in these countries.

In the long-term there may be a net loss of foreign exchange earnings from LDCs leading to unsustainable BOP positions. This is because in the short-term there is only one-time injection of foreign exchange into LDCs, while in the long-term a steady stream of profits, royalty payments, as well as licence fees will flow out from LDCs. In the long-term particularly portfolio investments may create some problems. Such flows may be vary from year to year, injecting a greater volatility into host country's BOP. In addition, sudden inflows may be inflationary. However, it is highly difficult to measure the long-term effects of FDI on BOP due to the phenomenon of transfer pricing (Moran 1985).

3.4. TNCs and Export Performance

TNCs can improve export performance of LDCs by providing access to new markets, requisite inputs, technology and price competitiveness. When such investment is export-oriented, the impact of TNCs on export performance can be assessed at country level, industry level and company level. TNCs in export promotion in LDCs focus heavily on in the area of manufactures or non-traditional exports.

An empirical study, done on the country level by Santiago (1987) for Puerto Rica, indicates that a 1 % rise in FDI results in a 7 % increase in the average share of manufacturing exports. In addition, it has been estimated in the Mexican economy that in 1974, about 34.1 % of manufactured exports were made by foreign firms. However, the contribution of foreign firms in terms of exchange earnings (12.6 %) was lower than that of locally-owned firms (19.4 %) in 1974 (see Jenkins 1979). Export-oriented investment of TNCs in East Asian countries has enabled to increase their exports significantly. For instance, in China the share of FDI in total exports reached to 20 % and 30 % in 1992 and 1993 respectively (see Chen *et al.* 1995).

It is argued that the contribution of TNCs to exports and national income growth depends on the development level of countries. Their overall impact is likely to be greater for middle and high income countries than for countries at early stage of their development. The performance of TNCs is found to be mixed in exporting manufactures when compared with that of local firms in developing countries (Ahiakpor 1990; Weiss 1991).

Lall (1985) points out that a number of developing countries has not obtained sufficient export earning through TNCs. The reasons for this fact may be given as follows: wrong location, insufficient requisite materials and skills, as well as inadequate infrastructure in these countries. Thus, all these factors lead to very high cost and unstability for TNCs to commit themselves to world-wide sourcing from them.

3.5. TNCs, Employment and Human Resource Development

The impact of TNCs on employment can be observed directly, indirectly and qualitatively. World Investment Report (WIR 1992) shows that only about 7 million people were employed by TNCs in LDCs in the mid-1980s, which is just equal to 1 % of economically active population of LDCs. The share of TNCs in employment was seen significantly in export processing zones (EPZs) where nearly 2 million workers were employed in both traditional labour intensive manufacturing. TNCs can create large indirect employment by providing backward and forward linkages and by influencing employment in competing firms. However, there is no certain evidence regarding to the indirect employment effects of TNCs (TNCs in World Development 1988: 214).

TNCs may bring more efficient technical and managerial skills and may pay higher wages than domestic firms, but they create a small labour elite for themselves whilst transferring the bulk of the workers into the rank of unemployed (Moran 1985). They promote capital-intensive technology but most LDCs need labour-intensive technologies to create employment opportunities for their increasing population. In addition, TNCs may create a

dualism in the labour market. If they pay local labour too low a wage in relation to its contribution to production, they may exploit host country's resource. If they pay higher wages than local firms, they may accelerate the gap between their own labour force and the rest of the local labour force.

On the other hand, TNCs can assist human resource development by introducing new technology and training, particularly their employees in requisite skills. However, these skills may be only TNC specific and not applicable for local firms.

3.6. TNCs and Environment

In LDCs, TNCs operate especially environmentally sensitive areas such as mining, petroleum extraction, chemical processing, refining of heavy metals, wood and paper processing and motor vehicles. The process and products of TNCs in these areas may have a potential danger on both human health and environment. As a consequence, the role of TNCs in environmental matter became a subject of global concern. There are evidences that TNCs are damaging the environment more than domestic industries. For instance, the mishaps of Chernobyl in former USSR and Bhopal in India are the gifts of TNCs, which damaged seriously the environment and human lives. In addition, due to TNC activities nearly 25 % of Central America's rain forest has turned to grass. However, TNCs have access to both resources and environmental-friendly technology, and also have a global image to protect environment (WIR 1992). LDCs can put pressure on TNCs for the transfer of such technology.

3. 7. TNCs and Transfer Pricing

TNCs have an incentive to manipulate the intra-firm prices in order to reduce their overall tax liabilities and to increase their competitive position in the foreign markets. They can avoid to pay much local tax in high-tax countries and shift profits to affiliates in low-tax countries by artificially rising the price they pay for their intermediate products purchased from overseas affiliates so as to reduce their stated local profits. This phenomenon is known as 'transfer pricing' and it is one of the very common practices of TNCs. Transfer pricing can cause a substantial reduction in revenues of host countries from TNCs' activities as well as distort their planning, which in turn may result in misallocation of scarce resources in the long-term. In Latin American pharmaceutical industry, for example, nearly 80 % of TNCs profits are repatriated through transfer pricing (Colman and Nixson 1994).

Therefore, the control of transfer pricing policies of TNCs become a significant issue for host country governments. In order to avoid transfer price manipulations, an international mechanism might be necessary to ensure that TNCs should not escape from taxation through transfer pricing. For this

purpose, the following actions can be taken:

i.Need for more adequate disclosure: There can be a need to disclose more about the business practices of international price setting. For this purpose, attention should be paid not only to a particular subsidiary, but also to overall operational aspects of TNCs.

ii.International harmonisation of taxes and regulations: some regulations, covering specific guidelines and principles, on tax matters can be done among all countries. Thus, the internal pricing practice can become more acceptable to the governments involved.

iii.International co-operation and adjustment: Co-operation among governments can maintain their sovereign rights to protect their own regulations as well as can improve the exchange of relevant information.

3. 8. Socio-culturel Aspects of TNCs

It is argued that the production of TNCs is appropriate for the needs of local elite rather than ordinary people. They may also encourage inappropriate consumption patterns through advertising and through their monopolistic market power (Todaro 1989; 1994). In addition, TNCs may influence the public opinion and may interfere elections in the interest of a foreign power or ideology; they may destroy domestic culture and traditions by introducing new and cheap goods.

4. Conclusion

Although the arguments both for and against FI are still far from being settled empirically, FI can be an important stimulus to economic and social development as long as the interests of TNCs and host country governments coincide. Indeed, today many LDCs desire to get benefit from FI. It can contribute to the economic growth of LDCs via channels such as technological progress, human resource development, managerial skills, etc. They also can provide considerable effect on consumption pattern, appropriateness of the technology and distribution of power and wealth. Real contribution of TNCs depends on the structure of the industry, the design of host government policies, and the evolution of the foreign investor-host country relationship (Moran 1985). However, sometimes strong controls are necessary for TNC activities due to their oligopolistic powers and the ability to transfer profits undetected. In addition, it may be possible to improve the bargaining power of LDCs by means of collecting information, international corporation, etc.

The government policy related to foreign investment should determine areas where TNCs could be beneficial for the economy and what the cost of them is likely be in terms of their social and economic impact. FI could be

encouraged where it provides resources-either of technology, foreign finance or management-that would otherwise be lacking or available at higher cost. Appropriate government policies, such as an unbiased trade regime, market reform and co-operation among LDCs, could ensure more benefits from foreign investment than costs. For this purpose, the role of incentives in determining the selection of techniques in LDCs has been widely recognised in the literature; prompting call for governments in LDCs to get the prices right. Under the right set of policies and circumstances FI could be beneficial to both foreign investors and the host LDCs.

ÖZET

Bu çalışma yabancı sermayenin gelişmekte olan ülkelerin gelişme potansiyelleri üzerindeki rolü ve etkisi ile ilgili farklı görüşleri inceler. Genel olarak yabancı sermaye bu ülkelere çokuluslu şirketler aracılığıyla girer. Bu şirketler birden fazla ülkede yatırım yapan; finansal sermaye, yönetim, teknoloji ve pazarlama organizasyonu sağlayan ve global olarak kar arayan kuruluşlardır. Yabancı sermayenin, gelişmekte olan ülkelerin gelişme potansiyelleri üzerindeki rolü ve etkisi konusundaki tartışmalar aşağıdaki alanlarda odaklaşmaktadır: Ekonomik büyüme, teknoloji transferi, ödemeler dengesi, ihracat performansı, istihdam, çevre, transfer fiyatlandırma ve çokuluslu şirketlerin sosyo-kültürel etkileri. Sonuç olarak bu çalışma göstermektedir ki, gelişmekte olan ülkelerde tarafsız ticaret rejimi, piyasa reformu ve işbirliği gibi uygun hükümet politikalarının varlığı halinde, bu ülkeler yabancı sermayeden daha fazla elde edebilirler.

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