III The Role of Foreign Direct Investment in Development

There is considerable controversy about the relative costs and benefits of foreign direct investment to developing countries. The principal argument in its favor is that the package of capital and technological and managerial resources generally increases the real domestic income of the host country by more than the profits returned to the investor. This increase is manifested in higher tax revenues, higher labor incomes, or lower prices. Moreover, since profits are earned only when the investment earns a positive return, part of the risk is borne by the foreign investor. Nevertheless, the association of direct investment with some degree of overseas managerial control, and generally with large transnational companies, can have wide-ranging effects on the economy of the host developing country. Concern that some of the activities of the enterprise might have adverse consequences for a country's development prospects may lead to the adoption of restrictive policies toward foreign direct investment. This concern has been reinforced by dissatisfaction with some of the results of earlier investments.

In assessing the overall effects of direct investment, however, it is relevant that many of the principal benefits and costs can be substantially affected by the economic policies of the host country. In particular, the types of investment projects chosen will depend on relative prices in the host country; if these are inappropriate, the investment will also be inappropriate and of less benefit to the economy. The foreign investors themselves can also help to ensure that the direct investment process is mutually beneficial by cooperating with a host country's chosen development strategy and showing willingness, where necessary, to consider alternative arrangements, such as joint ventures and minority equity participation.

Transfer of Resources

There are wide variations in the extent to which different developing countries have relied on direct investment. Such inflows have made an important contribution to total capital formation in only a few developing countries since 1973, as many countries turned to overseas borrowing as a source of foreign savings. Between 1979 and 1981, direct investment inflows represented about 25 percent and 11 percent of total fixed capital formation in Singapore and Malaysia, respectively; around 5 percent in Chile and the Philippines; only about 1.5 percent in Brazil, Indonesia, and Mexico; while they were negligible in India, Korea, and Nigeria. However, these measures understate the contribution of foreign-owned enterprises to gross capital formation. Reinvested earnings are not recorded for some developing countries; in addition, the depreciation funds of direct investment enterprises, which are not included in the definition of direct investment, finance a substantial proportion of their gross capital expenditures.

There are major differences among countries in the degree to which direct investment can be substituted for other forms of foreign capital inflow. (The issue of whether, on the supply side, international capital markets could have coped with a large-scale substitution of direct investment for overseas commercial borrowing on the part of developing countries as a group is discussed in Section V.) The differences in substitutability are the result both of variations in economic structure that affect countries' attractiveness to investors, and differences in the underlying macroeconomic causes of the need for capital inflows. Countries with small internal markets, few natural resources, a relatively underdeveloped infrastructure, and limited possibilities for manufactured exports may not be able to attract substantial direct investment, even with liberal regulations and generous incentives. Such countries are also generally not able to borrow significantly on commercial terms, and must rely primarily on concessional borrowing. Consequently, the possibilities for substitution between overseas commercial borrowing and direct investment mainly concern countries that are larger, better-endowed with natural resources, or that have a more developed industrial sector. Countries that already have a substantial amount of foreign-affiliated investment will also generally find it easier to influence the future composition of capital inflows, since they can also influence direct investment through the financial structure of existing subsidiaries of foreign companies, and in particular the amount of borrowing from domestic sources and from third parties abroad. But, as indicated in Section II, direct investment has tended to be even more concentrated in a few countries than has external borrowing.

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The macroeconomic causes of capital inflows can also have a large influence on the degree of substitutability between direct investment and commercial borrowing as sources of foreign capital. In countries with well-integrated capital markets, the particular sources of macroeconomic imbalance would have only a limited impact on the composition of capital inflows. However, most developing countries have fragmented domestic capital markets, and for them the causes of capital inflows are of greater significance. Three types of factors lead to a need for increased capital inflows, presenting varying possibilities for substitution between direct investment and external borrowing.

First, aggregate demand may increase relative to aggregate supply because of increased expenditure on investment projects that are regarded as financially viable. If such investment takes place in the private sector, then the potential for substitution is high, provided the tax and regulatory frameworks are suitable for direct investment. If the investment is undertaken mainly by state enterprises, then in many countries the potential for substitution is lower because of institutional barriers to the participation of foreign direct investment. Nevertheless, there could still be substantial possibilities for the participation of foreign equity through various forms of joint venture arrangements with the relevant state enterprises, provided these were consistent with the host country's overall development orientation. Such arrangements are common in mineral exploration and development, where much of the risk is borne by foreign equity capital operating in partnership with public corporations, but are also evident in many other sectors. Brazil has encouraged joint ventures involving a combination of state and both local and foreign private equity capital, particularly in the petrochemical industry. The experience of China, which at present uses foreign direct investment more than overseas commercial borrowing, demonstrates that a system of state enterprises need not be a barrier to substitution between different forms of foreign capital. One policy measure that has frequently reduced such substitutability has been the provision of government guarantees on overseas commercial bank borrowing by state enterprises. These lower the cost of commercial borrowing to the enterprise, since the government assumes part of the lender's risk, so it becomes relatively more attractive to the state enterprise than foreign equity participation.

Second, aggregate demand may rise relative to aggregate supply because of increased expenditure on consumption or on investment projects that are regarded as not financially viable, including infrastructure projects that might have high overall economic returns but that do not generate any revenue directly. Such excess demand frequently takes the form of larger fiscal deficits as government expenditure on subsidies, higher wage bills, or social infrastructure rises. In this situation, the possibilities for substituting foreign direct investment for overseas borrowing, which is usually undertaken directly by a government or central bank, are lower. There are no additional investment projects that would be attractive to direct investors. In principle, higher domestic borrowing by the government could drive up domestic interest rates, and lead to greater inflows of direct investment, in part by reducing domestic borrowing by transnational companies. In practice, however, such indirect effects on foreign capital flows are limited because capital markets are fragmented, and flexible interest rate policies do not exist in many developing countries.

Finally, part of the external borrowing of some developing countries has been used not to finance an increase in aggregate domestic expenditures, but to offset an outflow of private residents' capital. The possibilities for substituting direct investment for such borrowing are generally low, especially since the inappropriate exchange and interest rate policies that are often the cause of such capital flight are also likely to discourage direct investment.

Therefore, the extent to which different developing countries could have substituted foreign direct investment for part of their external borrowing over the last decade would have depended on how they used it. A significant proportion of the borrowing that took place immediately after the two large increases in oil prices was for short-term balance of payments support, for which the possibilities for substitution were probably quite low. However, the scope for switching between types of capital inflow probably increases with the length of the period after the initial external imbalance. In this regard, evidence presented in the Fund's *World Economic Outlook* for 1983 suggested that, for most of the largest borrowers among non-oil developing countries, the increase in external debt during the last decade was associated with a higher rate of investment and was not used primarily to finance consumption.[10] However, part of the higher investment must have been in infrastructural projects of a sort that would not have attracted foreign direct investment.

Technology transfers (including managerial and marketing expertise) are more difficult to measure than capital flows but, as discussed in Section II, a substantial proportion of such transfers took place between overseas parent companies and their subsidiaries. Once again, however, the importance of such intrafirm technology transfers relative to transfers between unrelated parties varied substantially among developing countries and across industries. In Korea, where direct investment was regulated and channeled into particular sectors, some three quarters of all overseas licensing agreements between 1973 and 1980 were concluded by locally-

[10] *World Economic Outlook*, Occasional Paper No. 21 (Washington, May 1983), Appendix A. Supplementary Note 7, pp. 140–44.

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owned firms; in Singapore, however, where there were relatively few restrictions on direct investment, most licensing agreements were entered into by firms that were at least partly foreign owned.[11] In industries with new or highly firm-specific technologies (such as the electronics industry), most transfers were between a parent company and its fully- or majority-owned affiliates, since there was concern with retaining close control of the technology involved. In many other industries, however, technology transfers through various licensing agreements grew more rapidly than the transfer of technology through direct investment.

Impact on Host Developing Countries

The overall economic impact of enterprises established through direct investment goes well beyond the direct transfer of capital and technology that they entail. Since these enterprises also borrow in the host country and from third parties abroad, they affect a share of total resources that is much larger than the recorded inflow of direct investment. Moreover, direct investment is often concentrated in import-substituting or export industries, so that the foreign trade performance of enterprises based on direct investment can have a significant impact on their host's balance of payments. Consequently, the achievement of development objectives can be significantly affected by the actions of foreign-controlled affiliates and their parent companies. Many developing countries have been concerned by the loss of local autonomy that this might imply. Moreover, substantial foreign ownership of major sectors of the economy has frequently been regarded as involving a weakening of indigenous industry and the growth of oligopolistic market structures which impose welfare costs on the population. In addition, it has been argued that foreign-controlled firms may adopt overly capital-intensive production techniques (which are available, but inappropriate), make insufficient transfers of technology at too high a cost (to retain technological advantage), set artificially high transfer prices (to extract excessive profits), and exert strain on the balance of payments (because, as part of an enterprise with multinational production facilities, they may be less able than firms under domestic control to expand exports and may be overly dependent on imports).

There can also be many indirect effects of foreign investment that are beneficial to the host country's economy. Such investment may contribute longer-term advantages in terms of improved productivity and international competitiveness. The presence of efficient firms that are competitive on world markets can provide a potentially important channel for transferring to host countries technological and managerial skills. This can take place within a particular industry, where suppliers of inputs to the foreign affiliate, domestic users of the affiliate's output, and its competitors may all be induced to adopt more efficient techniques. It can also occur more generally within the economy, through an eventual improvement in the level of training and experience of the labor force and through the possible encouragement of various financial and technical support industries that can lower all industrial costs.

Judgments on the permissible degree of foreign ownership and control involve broader political as well as economic considerations. Nor are such issues confined to developing countries, since groups in some industrial countries have also been apprehensive about the growth of foreign direct investment within their borders. Each host country, therefore, must determine the appropriate level of foreign participation in particular sectors in the light of its needs and objectives. It should be borne in mind, however, that many of the costs and benefits associated with direct investment can be strongly influenced by the host country's economic policies. The attitudes and policies of transnational companies can also play an important role in ensuring that the direct investment process is one of mutual benefit.

Foreign direct capital can have complex and wide-ranging effects on indigenous enterprises and the level of competition in a developing country. It can stimulate local entrepreneurship by providing increased competition and opportunities for subcontracting by local suppliers; it can also, however, reduce the number of locally-owned firms, either by takeover or because such firms are not able to compete with the greater resources of foreign-controlled subsidiaries. It is estimated, for instance, that around one third of foreign subsidiaries in developing countries were established through the acquisition of existing enterprises.[12] Whether such takeovers reduce overall competition would depend partly on the competitiveness of other firms in the industry. The policies of the host country also play an important role; the welfare costs of excessive market concentration are greater, for instance, when the domestic market is also insulated against competition from imports.

Because of the nature of technological information, it is transferred in a highly imperfect market in which it is often difficult to fix an exact price. Developing countries are frequently in a weak bargaining position in these markets, especially if they lack specialized manpower that can help determine the likely contribution of

[11] Bohn-Young Koo, "New Forms of Foreign Investment in Korea" and Pang Eng Fong, "Foreign Indirect Investment in Singapore" in Charles Oman, *New Forms of International Investment in Developing Countries*, Organization for Economic Cooperation and Development (Paris: OECD, 1984).

[12] R. Vernon, *Storm Over the Multinationals; the Real Issues* (Cambridge, Massachusetts: Harvard University Press, 1977), p. 72, based on data from the Harvard Multinational Enterprise Project.

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proposed technology transfers. This can be particularly so when the technology is transferred as one element of a package of resources provided by direct investment, since the exact cost of such technology is frequently unclear. Some developing countries have attempted to strengthen their bargaining positions by imposing limits on royalty payments (as a fixed percentage of total sales receipts, for instance) or by establishing vetting procedures for all technology contracts. The increased willingness of some transnational corporations to consider alternative forms of technology transfer—including licensing, franchising, and subcontracting—may help lower the costs of these transfers, especially for host countries that may not need other elements of a direct investment package, such as managerial or marketing skills.

It is frequently argued that since the technology transferred to developing countries through direct investment is generally developed for industrial countries, it involves overly capital-intensive techniques, especially since multinational enterprises conduct little research and development in most developing countries. There is some evidence that, in many developing countries, average capital-labor ratios of foreign subsidiaries in manufacturing are higher than those of local firms. However, this appears to be largely due to their greater concentration in industries with high capital requirements; differences in capital intensity between foreign- and locally-owned firms within the same industry are less clearcut. In any event, host country governments can significantly influence the choice of production techniques. A number of frequently adopted policies encourage the substitution of capital for labor; these include overvalued exchange rates that reduce the cost of imported capital equipment, administered interest rates below current rates of inflation, and various fiscal incentives for investment that reduce the cost of capital.

The external trade of foreign-controlled companies may be less responsive to shifts in relative competitiveness between the host country and its trading partners because much of it consists of intrafirm transactions. There are indications that such intrafirm trade between industrial countries is less sensitive to relative price changes than trade between independent producers, who are unconcerned with the effects of their actions on the profitability of other affiliates.[13] Although intrafirm trade is generally less important for developing than for industrial countries, it plays a major role in certain developing countries, particularly those with substantial exports from technology-intensive industries. In recent years, trade between related parties (parties of which one owns 5 percent or more of the voting stock of the other) accounted for only around one quarter of manufactured imports into the United States from all developing countries, compared with over one half of such imports from industrial countries. However, related-party trade accounted for around three quarters of manufacturing exports to the United States from Malaysia, Mexico, and Singapore, over one third of such exports from Brazil, but less than one tenth of those from Argentina and India.[14]

The transfer prices used in such intrafirm transactions can diverge from the equivalent "arm's length" market price that would be set in trade between unrelated parties. Although under- or over-invoicing to shift profits for tax purposes, or to evade foreign trade taxes or exchange controls, is a problem for all foreign trade, the opportunities for such actions are clearly greater in intrafirm trade. This places a correspondingly greater burden on the monitoring ability of customs services, especially for highly differentiated products (such as pharmaceuticals) or for specialized intermediate components for which there is often no ascertainable arm's length price.

As has already been mentioned, an inappropriate set of policies can significantly increase the costs and reduce the benefits of foreign direct investment in the host country. For example, much of the initial inflow of direct investment into the manufacturing industries of developing countries, particularly in Latin America, was to establish import-substituting production, and was encouraged by high tariff barriers and quantitative restrictions on imports. The results of such investment were frequently disappointing; costs of production were high, value added at international prices and exports were low, and dependence on imported intermediate inputs was significant. At the same time, import restrictions contributed to an overvalued exchange rate that, together with fiscal incentives granted to attract direct investment, increased the real resource costs of profits earned on the investment. Disappointed with these results, host developing countries frequently attempted to increase their net benefits by imposing more detailed regulations on direct investment, including requirements for a minimum level of exports or local value added. Nevertheless, such regulations were generally less effective than more open exchange and trade policies would have been. The effects of more open trade policies were apparent in Singapore and Korea, where affiliates of multinational companies were responsible for some 90 percent and 27 percent, respectively, of total manufactured exports in the late 1970s, even though their share of total manufacturing sales in these countries was much smaller (around 30 percent and 10 percent, respectively).[15]

[13] David J. Goldsbrough, "International Trade of Multinational Corporations and its Responsiveness to Changes in Aggregate Demand and Relative Prices," *Staff Papers*, International Monetary Fund (Washington), Vol. 28 (September 1981).

[14] G.K. Helleiner, *Intra-Firm Trade and the Developing Countries* (New York: St. Martin's Press, 1981).

[15] Oman, op. cit.

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Transnational corporations can help reduce developing countries' concerns about foreign economic influence by respecting the economic and social objectives and priorities of host governments and by signalling their willingness to abide by generally acceptable standards of behavior in such areas as transfer pricing, restrictive business practices for both domestic and international trade, and the transfer of technology. International codes of conduct, such as the code established under the auspices of the Organization for Economic Cooperation and Development (OECD) or the more comprehensive code still being discussed under the auspices of the United Nations, may help to reduce potential areas of conflict in this area by setting guidelines for the responsibilities of both investing companies and host governments.[16] The growing diversity of sources of foreign direct investment, and an increased willingness by many investors to consider arrangements other than wholly- or majority-owned affiliates, may also help reduce concerns prevalent in host countries about loss of local autonomy.

Thus, although the overall costs and benefits derived from specific direct investments depend on the particular circumstances of each country and each project, it is evident that direct investment can be of mutual advantage to the host country and the foreign investor. Moreover, its net benefits can be strongly influenced by the host country's economic policies. The distribution of any net gains will depend, in part, on the relative bargaining position of the direct investor and the host country, but there are clearly opportunities for mutual advantage through policies that can both increase the attractiveness of a country to potential investors and increase the likely benefits that the country receives from such investment.

[16] Organization for Economic Cooperation and Development, *Declaration by the Governments of OECD Member Countries and Decisions of the OECD Council: On Guidelines for Multinational Enterprises, National Treatment, International Investment Incentives and Disincentives, and Consultation Procedures* (Paris: OECD, 1976); *Declaration by the Governments of OECD Member Countries and Decisions of the OECD Council: On International Investment and Multinational Enterprises* (Paris: OECD, 1984).

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