**Unit 6**

**FOREIGN DIRECT INVESTMENT AND AID**

**Pretest**

Dear learners, what do you think about the role of investment by foreign companies in the development of a country’s economy? What about foreign aid? Briefly discuss.

**6.1 Private Foreign Direct Investment and the Multinational Corporation**

 International flow of financial resources takes two main forms:

(1) Private foreign direct and portfolio investment: (a) foreign "direct" investment by large multinational corporations and (b) foreign "portfolio investment in LDC "emerging" credit and equity markets by private institutions; and

(2) Public and private development assistance, from (a) individual national governments and multinational donor agencies and, increasingly, (b) private non-governmental organizations, most working directly with developing nations at the local level.

Few developments have played as critical a role in the extraordinary growth of international trade and capital flows during the past few decades as the rise of the multinational corporation (MNC). The huge firms, mostly from North America, Europe, and Japan (but also increasingly from newly industrializing countries like South Korea, Taiwan, and Brazil) present a unique opportunity, but may pose serious problems for the many developing countries in which they operate.

Multinational corporations are not in the development business; their objective is to maximize their return on capital. This is why over 90% of global FDI goes to other industrial countries and the fastest growing LDCs. MNCs seek out the best profit opportunities and are largely unconcerned with issues such as poverty, inequality, and unemployment alleviation.

Despite their insignificance in terms of the overall national employment picture, these corporations often exert a disproportionate influence on urban salary scales and migrant worker perceptions.

But foreign direct investment involves much more than the simple transfer of capital or the establishment of a local factory in a developing nation. Multinationals carry with them technologies of production, tastes, and styles of living, managerial philosophies, and diverse business practices including cooperative arrangements, marketing restrictions, advertising, and the phenomenon of "transfer pricing". They engage in a range of activities, many of which have little to do with the development aspirations of the countries in which they operate.

**6.1.1 Private Foreign Investment: Some Pros and Cons for Development**

1. **Traditional Economics Arguments in Support of Private Investment: Filling Savings, Foreign-Exchange, Revenue, and Management Gaps**

The pro-foreign-investment arguments grow largely out of the traditional neoclassical and new growth theory analysis of the determinants of economic growth. Foreign private investment is typically seen as a way of filling in gaps between the domestically available supplies of savings, foreign exchange, government revenue, and human capital skills and the desired level of these resources necessary to achieve growth and development targets.

The first and most often cited contribution of private foreign investment to national development is its role in filling the resource gap between targeted or desired investment and locally mobilized savings.

The second is filling the gap between targeted foreign-exchange requirements and those derived from net export earnings plus net public foreign aid.

The third gap said to be filled by foreign investment is the gap between targeted governmental tax revenues and locally raised taxes.

Fourth, there is a gap in management, entrepreneurship, technology, and skill presumed to be partly or wholly filled by the local operations of private foreign firms.

(2) **Arguments against Private Foreign Investment: Widening Gaps**

There are two basic arguments against private foreign investment in general and the activities of MNCs in particular.

 Although MNCs provide capital, they may lower domestic savings and investment rates by stifling competition through exclusive production agreements with host governments, failing to reinvest much of their profits, generating domestic incomes for groups with lower savings propensities, and inhibiting the expansion of indigenous firms that might supply them with intermediate products by instead importing these goods from overseas affiliates. MNCs also raise a large fraction of their capital locally in the developing country itself; and this may lead to some crowding out of investment of local firms.

ii. Although the initial impact of MNC investment is to improve the foreign exchange position of the recipient nation, its long-run impact may be to reduce foreign- exchange earnings on both current and capital accounts. The current account may deteriorate as a result of substantial importation of intermediate products and capital goods, and the capital account may worsen because of the overseas repatriation of profits, interest, royalties, management fees, and other funds.

iii. Although MNCs do contribute to public revenue in the form of corporate taxes, their contribution is considerably less than it should be as a result of liberal tax concessions, the practice of transfer pricing, excessive investment allowances, disguised public subsidies, and tariff protection provided by the host government.

iv. The management, entrepreneurial skills, ideas, technology, and overseas contacts provided by MNCs may have little impact on developing local sources of these scarce skills and resources and may in fact inhibit their development by stifling the growth of indigenous entrepreneurship as a result of the MNCs' dominance of local markets.

(3) **Reconciling the Pros and Cons**

The advocates of private foreign investment tend to be free-market, private-enterprise, laissez-faire proponents who firmly believe in the efficacy and beneficence of the free-market mechanism, where this is usually defined as a hands-off policy on the part of host governments. However, the actual operations of MNCs tend to be monopolistic and oligopolistic. Price setting is achieved more as a result of international bargaining and collusion than as a natural outgrowth of free- market supply and demand.

 Theorists who argue against the activities of MNCs are often motivated by a sense of the importance of national control over domestic economic activities and the minimization of dominance-dependence relationships between powerful MNCs and developing-country governments. They see these giant corporations not as needed agents of economic change but more as vehicles of antidevelopment. Multinationals, they argue, reinforce dualistic economic structures and exacerbate domestic inequalities with wrong products and inappropriate technologies. Rightly or wrongly, they view MNCs as modern incarnations of colonial devices such as the British East India Company. Many analysts advocate a more stringent regulation of foreign investments, a tougher bargaining stance on the part of host governments, a willingness on the part of LDCs to "shop around" for better deals, the adoption of performance standards and requirements, increased domestic ownership and control, and a greater coordination of LDC strategies with respect to terms and conditions of foreign investment.

 The arguments both for and against private foreign investment are still far from being settled empirically and may never be as they ultimately reflect important differences in value judgments and political perceptions about desirable development strategies.

Perhaps the strongest argument in favor of encouraging MNCs is that they facilitate the transfer of know-how from developed to developing countries. Dani Rodrik surveyed the literature and concluded that, so far, there has been little evidence of any horizontal spillovers, that is, the spillover of knowledge from MNCs to local producers of the same type of product. However, Garrick Blalock reported both statistical and managerial case study evidence for Indonesia that provides strong indications that MNCs strategically transfer technology to local vendors so that multinationals can procure high-quality inputs at low cost. Thus, there is at least a suggestion that there may indeed be some significant technology spillovers, at least for Indonesia, but that the spillovers are vertical rather than horizontal in nature.

 The quantitative and qualitative impact of MNC investments in developing countries remains to be assessed. As a result of the widespread adoption of market reforms, open economies, and privatization of state-owned enterprises, MNCs have been intensifying their global factory strategy, particularly in Asia and Latin America. They will add to national output, create some jobs, pay some taxes, and generally contribute to a more modern economy. But they will also gravitate toward the most profitable investment opportunities, purchase local factories of depressed LDC economies at "fire sale" prices, engage in transfer pricing, and repatriate profits. Whether the net outcome is more positive for development than in the past remains to be assessed. It is to be hoped that ways can be found in which MNC profits and broad-based national development can be simultaneously served.

**6.2 Foreign Aid: The Development Assistance Debate**

**6.2.1 Conceptual and Measurement Problems**

In addition to export earnings and private foreign direct and portfolio investment, the final two major sources of LDC foreign exchange are public (official) bilateral and multilateral development assistance and private (unofficial) assistance provided by Non-governmental organizations. Both of these activities are forms of **foreign** aid, although only public aid is usually measured in official statistics.

 In principle, all governmental resource transfers from one country to another should be included in the definition of foreign aid. Even this simple definition, however, raises a number of problems. For one thing, many resource transfers can take disguised forms, such as the granting of preferential tariffs by developed countries to LDC exports of manufactured goods. This permits LDCs to sell their industrial products in developed- country markets at higher prices than would otherwise be possible. There is consequently a net gain for LDCs and a net loss for developed countries, which amounts to a real resource transfer to the LDCs. Such implicit capital transfers, or disguised flows, should be counted in qualifying foreign aid flows. Normally, however, they are not.

However, we should not include all transfers of capital to LDCs, particularly the capital flows of private foreign investors. Private flows represent normal commercial transactions, are prompted by commercial considerations of profits and rates of return, and therefore should not be viewed as aid to the LDCs. Commercial flows of private capital are not a form of foreign assistance, even though they may benefit the developing

country in which they take place.

Economists have defined foreign aid, therefore, as any flow of capital to LDCs that meets two criteria: (1) Its objective should be noncommercial from the point of view of the donor, and (2) it should be characterized by concessional terms; that is, the interest rate and repayment period for borrowed capital should be softer (less stringent) than commercial terms. Even this definition can be inappropriate, for it could include military aid, which is both noncommercial and concessional. Normally, however, military aid is excluded from international economic measurements of foreign aid flows. The concept of foreign aid that is now widely used and accepted, therefore, is one that encompasses all official grants and concessional loans, in currency or in kind, that are broadly aimed at transferring resources from developed to less developed nations on development or income distribution grounds. Unfortunately, there often is a thin line separating purely developmental grants and loans from sources ultimately motivated by security or commercial interests.

 Just as there are conceptual problems associated with the definition of foreign aid, so too there are measurement and conceptual problems in the calculation of actual development assistance flows. In particular, three major problems arise in measuring aid. First, we cannot simply add together the dollar values of grants and loans; each has a different significance to both donor and recipient countries. Loans must be repaid and therefore cost the donor and benefit the recipient less than the nominal value of the loan itself. Conceptually, we should deflate or discount the dollar value of interest-bearing loans before adding them to the value of outright grants. Second, aid can be tied either by source (loans or grants have to be spent on the purchase of donor-country goods and

services) or by project (funds can only be used for a specific project, such as a road or a

steel mill). In either case, the real value of the aid is reduced because the specified source is likely to be an expensive supplier or the project is not of the highest priority (otherwise, there would be no need to tie the aid). Furthermore, aid may be tied to the importation of capital-intensive equipment, which may impose an additional real resource cost, in the form of higher unemployment, on the recipient nation. Or the project itself may require purchase of new machinery and equipment from monopolistic suppliers while existing productive equipment in the same industry is being operated at very low levels of capacity. Finally, we always need to distinguish between the nominal and real value of foreign assistance, especially during periods of rapid inflation. Aid flows are usually calculated at nominal levels and tend to show a steady rise over time. However, when deflated for rising prices, the actual real volume of aid from most donor countries has declined substantially during the past decade. For example, during the period 1960-

1. The nominal outflow of foreign aid from the United States increased by 130%, but the real value actually declined by nearly 30%.

**6.2.2 Why Donors Give Aid**

Donor-country governments give aid primarily because it is in their political, strategic, or economic self-interest to do so.

1. **Political Motivations**

Political motivations have been by far the more important for aid-granting nations, especially for the major donor country, the United States. The United States has viewed foreign aid from its beginnings in the late 1940s under the Marshall Plan, which aimed at reconstructing the war-torn economies of Western Europe, as a means of containing the international spread of communism. When the balance of cold-war interests shifted from Europe to the developing world in the mid1950s, the policy of containment embodied in the U.S. aid program dictated a shift in emphasis toward political, economic, and military support for "friendly" less developed nations, especially those considered geographically strategic. Most aid programs to developing countries were therefore oriented more toward purchasing their security and propping up their sometimes-shaky regimes than promoting long-term social and economic development.

**ii. Economic Motivations and Self-Interest**

The increasing tendency toward providing loans instead of outright grants and toward tying aid to the exports of donor countries has saddled many LDCs with substantial debt repayment burdens. It has also increased their import costs because aid tied to donor- country exports limits the receiving nation’s freedom to shop around for low-cost and suitable capital and intermediate goods.

**6.2.3 Why LDC Recipients Accept Aid**

The reasons why developing nations, at least until recently, have been eager to accept aid, even in its most stringent and restrictive forms have been given much less attention than the reasons why donors provide aid. The major reason is probably economic. Developing countries have often tended to accept uncritically the proposition-typically advanced by developed-country economists, taught in all university development courses, and supported by reference to success stories like Taiwan, Israel, and South Korea to the exclusion of many more failures-that aid is a crucial and essential ingredient in the development process. It supplements scarce domestic resources, it helps transform the economy structurally, and it contributes to the achievement of LDC takeoffs into self- sustaining economic growth. Thus, the economic rationale for aid in LDCs is based largely on their acceptance of the donor’s perceptions of what the poor countries require to promote their economic development.

 Conflicts generally arise, therefore, not out of any disagreement about the role of aid but over its amount and conditions. Naturally, LDCs would like to have more aid in the form of outright grants or long-term low-cost loans with a minimum of strings attached. This means not tying aid to donor exports and granting greater latitude to recipient countries to decide for themselves what is in their best long-run development interests. Unfortunately, a good deal of aid that comes in this form has either been wasted in showcase but unproductive projects (e.g., monuments to the ruling family, an elaborate parliamentary building, an oversized airport) or actually been plundered by corrupt government officials and their local cronies. Much of the criticism of foreign aid-that it wastes resources, that it bolsters corrupt regimes, that it is appropriated by the rich at the expense of the poor-is justified. Some LDC recipients in the past have accepted aid simply because it was there and they were not held accountable. A few leaders simply wish to leave no stone unturned in their quest for poverty alleviation, as perhaps describes Mozambique in the 1990s. But they are the minority.

 Second, in some countries, aid is seen by both donor and recipient as providing greater political leverage to the existing leadership to suppress opposition and maintain itself in power. In such instances, assistance takes the form not only of financial resource transfers but of military and internal security reinforcement . South Vietnam provided the most dramatic illustration of this aid phenomenon in the 1960s, as perhaps Iran did in the 1970s and Central America in the 1980s. The problem is that once aid is accepted, the ability of recipient governments to extricate themselves from implied political or economic obligations to donor and prevent donor governments from interfering in their internal affairs can be greatly diminished.

Finally, whether on grounds of basic humanitarian responsibilities of the rich toward the welfare of the poor or because of a belief that the rich nations owe the poor nations conscience money for past exploitation, many proponents of foreign aid in both developed and developing countries believe that rich nations have an obligation to support LDC economic and social development. They then go on to link this moral obligation with the need for greater LDC autonomy with respect to the allocation and use of aid funds. The most recent example of this phenomenon was at the 1992 Earth Summit (UNCED) held in Rio de Janeiro. Here developing nations pressed for substantial increases in foreign aid to permit them to pursue environmentally sustainable development programs. Implicit was the notion that industrialized countries were the major polluters of the world and they had no business telling LDCs to slow their growth to save the planet.

 **The Growing Role of Non-governmental Organizations (NGOs)**

While there is much debate about the pros and cons of multinational corporate investment and public foreign aid in developing countries, few people doubt· the value of one of the fastest growing and most significant forces in the field of development assistance, private **nongovernmental organization**. NGOs are voluntary organizations that work with and on behalf of mostly local grassroots people's organizations in developing countries. They also represent specific local and international interest groups with concerns as diverse as providing emergency relief, protecting child health, promoting women's rights, alleviating poverty, protecting the environment, increasing food production, and providing rural credit to small farmers and local businesses. NGOs build roads, houses, hospitals, and schools. They work in family-planning clinics and refugee camps. They teach in schools and universities and conduct research on increasing farm yields.

 NGOs include religious groups, private foundations and charities, research organizations, and federations of dedicated doctors, nurses, engineers, agricultural scientists, and economists. Many works directly on grassroots rural development projects; others focus on relief efforts for starving or displaced peoples. Some familiar NGOs include Save the Children, CARE, Oxfam, Planned Parenthood, World Vision, the World Wildlife Fund, and Habitat for Humanity, the Ford Foundation, Christian Aid, Project HOPE, and Amnesty International. Between 1970 and 1990, funding devoted to developed-country NGO projects and programs in LDCs grew from just under $1 billion to over $5 billion. Almost half of that total came from the United States, even though the highest per capita contributions to NGOs carne from Sweden, Switzerland, Norway, and Germany. Many give full local control to their LDC affiliates or other local groups they support.

The great value of NGOs is twofold. First, being less constrained by political imperatives and motivated largely by humanitarian ideals, most NGOs are able to work much more effectively at local levels with the very people that they are trying to assist than massive bilateral and multilateral aid programs could. Second, by working directly with local people's organizations, many NGOs are able to avoid the suspicion and cynicism on the part of the mostly poor people that they serve that their help is less than sincere or likely to be short-lived. It is estimated that NGOs in developing countries are affecting the lives of some 250 million people; the fact that their voices are increasingly being listened to in the halls of developed country governments and at international conferences on development, makes it clear that the nature and focus of foreign aid are changing rapidly.

**6.2.4 The Effects of Aid**

The issue of the economic effects of aid, especially public aid, like that of the effects of private foreign investment, is fraught with disagreement. On one side are the economic traditionalists, who argue that aid has indeed promoted growth and structural transformation in many LDCs. On the other side are critics who argue that aid does not promote faster growth but may in fact retard it by substituting for, rather than supplementing, domestic savings and investment and by exacerbating LDC balance of payments deficits as a result of rising debt repayment obligations and the linking of aid to donor-country exports.

Official aid is further criticized for focusing on and stimulating the growth of the modern sector, thereby increasing the gap in living standards between the rich and the poor in developing countries. Some critics on the left would even assert that foreign aid has been a positive force for antidevelopment in the sense that it both retards growth through reduced savings and worsens income inequalities. Rather than relieving economic bottlenecks and filling gaps, aid-and for that matter private foreign investment-not only widens existing savings and foreign exchange resource gaps but may even create new ones (e.g. urban-rural or modern-sector-traditional-sector gaps). Critics on the right charge that foreign aid has been a failure because it has been largely appropriated by corrupt bureaucrats, has stifled initiative, and has generally engendered a welfare mentality on the part of recipient nations.

 Quite apart from these criticisms, donor countries over the past two decades have grown increasingly disenchanted with official foreign aid as domestic issues such as unemployment, government deficits, and balance of payments problems gained priority over international politics. The mood was one of aid weariness Taxpayers wanted to focus on domestic economic problems, especially as they came to realize that their tax dollars allocated to foreign aid were often benefiting small elite groups in LDCs who in many cases were richer than themselves. However, in recent years there has been an increasing willingness on the part of the public to donate development assistance via NGOs.