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Article — Digitized Version

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Intereconomics

Suggested Citation: Kebschull, Dietrich (1980) : Effects of foreign direct investment in developing countries, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 15, Iss. 5, pp. 235-240,
<http://dx.doi.org/10.1007/BF02924579>

This Version is available at:

<http://hdl.handle.net/10419/139701>

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Effects of Foreign Direct Investment in Developing Countries

by Dietrich Kebschull, Hamburg/Jakarta*

The effects of direct investments and multinational corporations remain a highly contentious issue. The author traces here the reasons for the large number of diverging statements and comments on this issue and considers what political conclusions should be drawn from this wide variety of views.

The direct investments are still in all their aspects a subject of fierce controversy¹. Ideologically motivated expressions of unqualified approval as well as adamant opposition are met. They are however overshadowed by the numerically much more important group of commentators who on the strength of empirical analyses attempt to stave off the suspicion of unrealistic theorizing by allowing for the manifold positive and negative factors and causal connections. Needless to say, there are wide divergences also within this group. These are essentially due to the underlying assumptions, whether conscious or unconscious, overt or covert.

To comprehend the diversity of statements, it seems therefore necessary to start with a sketch of the most important schools of thought and methods. Three main strands have to be kept apart:

- the schools leaning towards political economics,
- the advocates of a purely market-economic, especially neo-classical theory, and
- the ideologically less firmly committed empirical researchers.

Assessments with a Political-Economic Tenor

Support for the rejection of direct investments as a means of economic and social development comes at present in the main from two groups:

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the anti-capitalistic social scientists working on the basis of marxist theory, and

the *dependencia* school domiciled in southern and central America.

From the point of view of marxism and theories devoluted from it the concept of private investment involves automatically and inseparably the rejection in principle of private ownership of means of production, the prerequisite to the exploitation of the working class by the owners. This exploitation on a national and world-wide scale is deemed to be the decisive cause of the economic backwardness of the developing countries. Private investments – especially by foreigners – are nothing but Trojan horses of western colonialism and imperialism against the Third World. They always serve the purpose of exploitation and are for this reason consistently rejected².

For this line of argument the effects of such investments in an individual instance are irrelevant. Their very existence is tantamount to exploitation. It is not denied that larger or smaller groups of employees derive economic advantages from the activities of these enterprises but these are interpreted as attempts to split the revolutionary working class by quasi-

¹ For a brief review of the international discussion cf. A. Tharakan, in ECSM (ed.): *The International Division of Labour and Multinational Companies*, Westmead 1979; also P. J. Burkley: *Alternative Theories of the Multinational Enterprises*, University of Reading, Discussion Papers in International Investment and Business Studies, No. 23, April 1975.

² Cf. S. Amin: *Underdevelopment and Dependence in Black Africa – Their Historical Origins and Contemporary Forms*, in: *Social and Economic Studies*, Vol. 11, No. 1.

corruptive methods, which merely delay or prevent the revolution indispensable for development.

The various approaches passing nowadays under the collective designation of *dependencia* theories are likewise less concerned with the determination of the actual, in the short term ascertainable effects than with the demonstration of the existence of a dependent relationship which is the cause both of underdevelopment and of its perpetuation. The expounders of *dependencia* ascribe the blatant economic differences between the North and the South to the fact of dependence and to the, in their view, inescapably following exploitation of the periphery of the world economy (the developing countries) by the politically and economically overpowering centre (the industrialized states)³. The metropolises at the centre are according to the *dependencia* approach building bridgeheads in the peripheries and allying themselves to the oligarchies in these countries in order to be able to fully exploit their power potential. In this line of argument the direct investments are obviously regarded as institutionalized links between the centres of the world economy and its periphery.

According to the *dependencia* theories with an only very limited regard for economic aspects – similar in this respect to the marxists and derivative schools of thought – the macro- and micro-economic effects of the investments also do not matter. Several of their representatives recognize these effects, but this does not alter their fundamental opinion that they are instruments for preserving and consolidating the dependent status which has to be rejected.

Analyses of “Économie Pure”

The western-type theories of the market economy and the strategies derived from them offer a similarly extreme interpretation of the role of private investments in developing countries, albeit from the opposite end of the spectrum. For their supporters whose views are best circumscribed by the terms

market economy and free trade there can be no doubt about the positive effects of all private investment.

Direct investments are to them generically additional investments in the developing countries. Besides, they mostly do not involve an abstention from investments in the country of origin. To the country in which the investment is made it provides employment, income, technology and thus ultimately and invariably growth. Moreover, the investments allow the balance of payments to be improved through import substitution and expansion of exports and thus help by means of the directive mechanisms of the market economy to solve structural problems specific to a region or sector – provided the existence of such problems is recognized at all.

Typical of such unreserved affirmation of direct investments are the various investment multiplier and accelerator designs for simple growth models of the Harrod-Domar type and their refined versions of Kurihara, Solow and others⁴. In these models the investment is usually the crucial strategic variable. It is held to be of similarly great importance in current development strategies for the Third World, for instance in the “Big Push” model, in Hirschman’s unbalanced growth proposition and Rostow’s Take-off concept⁵.

It should be noted that in strategies of western-type economies in which other factors form strategic variables private investments are also of cardinal importance, as can be shown by the example of the export-oriented growth concepts in particular. The integration of the developing countries into the world economy by means of increased exports on which these insist presupposes private enterprises and investments by them. Where they do not exist in sufficient numbers they have necessarily to be augmented by foreign investors⁶.

The extreme approach leaves in its simple form no room for the question whether existing enterprises in the developing country are impaired or displaced by

³ Cf. O. Sunkel: National Development and External Dependence in Latin America, in: Journal of Development Studies, Vol. 6, No. 1, London 1969/70, p. 23 ff; S. Amin, Underdevelopment and Dependence in Black Africa . . . , *ibid.*, p. 177 ff; for a comprehensive review cf. A. Schmidt (ed.): Strategien gegen Unterentwicklung – zwischen Weltmarkt und Eigenständigkeit (Strategies against underdevelopment – between world market and independence), Frankfurt/New York 1976.

⁴ Cf., e. g., A. Woll: Allgemeine Volkswirtschaftslehre (General economics), 6th ed., Munich 1978, p. 302-326; G. Bombach: Wirtschaftswachstum (Economic growth), in: HdSW, Vol. 12, Göttingen 1965, p. 763-801; K. Rose: Grundlagen der Wachstumstheorie (Basic aspects of the growth theory), 3rd ed., Göttingen 1977; R. H. Solow: Wachstumstheorie (Growth theory), Göttingen 1971, and the specialized literature mentioned in these books.

⁵ Cf., e. g., the work of S. Enke: Economics for Development, Englewood Cliffs 1963; W. W. Rostow: The Take-off into Self-Sustained Growth, in: The Economic Journal, Vol. 66, 1965; The Stages of Economic Growth, Oxford 1960; H. Leibenstein: Economic Backwardness and Economic Growth, New York 1963; P. N. Rosenstein-Rodan: Notes on the Theory of “Big Push”, in: H. S. Ellis, H. C. Wallich (ed.): Economic Development in Latin America, London 1961; and A. O. Hirschmann: The Strategy of Economic Development, New Haven 1958.

⁶ Cf. the studies of Kieler Institut für Weltwirtschaft, esp. H. Giersch (ed.): The International Division of Labour, Tübingen 1978. The World Bank strategies for the development of Third World countries point clearly in this direction, especially during the fifties and sixties.

additional investments. With the assumption that these investments are additional goes a further assumption, namely that possible limitations of finance, employment, etc., are outbalanced by a functioning market mechanism. This assumption of an existing harmony has however met with a great deal of criticism among western bourgeois economists who believe it to be of too little validity and explanatory value in the reality.

Empirical-Pragmatic Approaches

These critics believe a greater emphasis on empirical investigations to offer a remedy. These are to make up for the lacking realism of the purely model-theoretical approach. They set out from an elucidation of the question to what extent direct investments truly supplement or displace indigenous investments. The judgment on the effects of direct investments is affected by the evaluation of this so-called alternative position and besides by

- whatever consideration is given to the repercussive effects of the investment for the economy as a whole, and
- differences in the methods used to ascertain the effects.

Basically the two alternatives in regard to the supplementary character of a foreign investment are as follows:

- The foreign investment is additional to the investment of the developing country, in which case the production, employment, exports, training, etc., resulting from it would truly be of a supplementary nature and the primary micro-economic effects would be matched by the additional macro-economic benefits;
- The foreign investment takes the place of an investment which would otherwise be made by domestic investors, in which case the effects ensuing from the investment must be balanced against the corresponding absence of effects of the omitted domestic investment. The net effects are thus much smaller than those of an additional investment. Their actual size depends upon the financing of the investment, chosen technology, market orientation, etc. It may indeed be a negative figure.

Both alternatives occur in practice relatively seldom. The problem of empirical studies consists therefore in

⁷ A comprehensive review of the results and the assumptions made can be found in R. G. Hawkins: *Job Displacement and the Multinational Firm: A Methodological Review*, Center for Multinational Studies, no indication of place of publication, 1972.

determining realistic variants between the two extremes and, when these have been ascertained, quantifying the effects.

Clearly two investigations into the same state of facts are bound to lead to entirely different results if started from the outlined opposite positions. This being so, they provide no basis for economic measures to foster or limit direct investments which are derived from their "findings". The margin of error of the – actually not yet experienced – effects can be reduced with the help of such studies but usable results can only be obtained by analyses which present the alternative position as it occurs in reality and can be taken up again. Nevertheless it is quite common for studies of relevance to economic policy to be launched from an extreme assumption, as emerges clearly from the discussion in the USA of the employment effects of direct investments. Different authors, setting out from different assumptions concerning the alternative position, arrive at completely opposite results⁷.

The judgment on foreign investments is liable to become still more confused if alternatives which are feasible in the country of origin are considered alongside the possible alternative position outlined for the country of investment. This happened first in the study on balance of payments effects by Hufbauer-Adler⁸ which counts by now among the classics of the literature on direct investments. These authors distinguish between three possible basic assumptions for each of which they ascertained the potential effects:

- The classical assumption that the investment in the developing country is a supplementary addition to the other investments (while the investments in the industrial country are reduced by an amount corresponding to the foreign engagement),
- The reversed classical assumption that the investment in the host country is not additional but substitutive (the investment in the country of origin is left unchanged), and
- The anti-classical assumption that the investment in question is effected additionally to the investments in the developing country without affecting the investments at home.

The fourth possibility, that of a substitutive effect of the foreign investment in the developing country to the

⁸ Cf. G. C. Hufbauer, F. M. Adler: *Overseas Manufacturing Investment and the Balance of Payments*, Tax Policy Research Study No. 1, U. S. Treasury Department, Washington, D. C., 1968; H.-E. Scharrer (ed.): *Förderung privater Direktinvestitionen. Eine Untersuchung der Maßnahmen bedeutender Industrieländer (Promotion of private direct investments. An investigation into the measures of important industrial countries)*, Hamburg 1972, p. 52 ff.

detriment of investments in the country of origin is regarded as unrealistic by Hufbauer-Adler.

This schema of variants has the advantage that the effects can be quantified in combination with simple models; the impression of mathematical accuracy which it conveys should not however be overrated, as is demonstrated by the studies of Hufbauer-Adler themselves. For the diversity of results obtained implies that they are not really usable for purposes of economic policy without specification of a realistic variant.

Consideration of Secondary Effects

The choice of an alternative position entails in itself different results and thus widely diverging assessments. Of importance is further the extent of the effects taken into consideration, for an analysis can be confined to the investment and the attendant effects on the enterprise in question or attempt to take all macro-economically relevant additional effects through forward and backward linkages into account. What difference this makes to the assessment can be easily demonstrated by taking the balance of payments effects as an example. Depending on the purpose of the analysis, these may be – economically correctly – identified in three ways:

1. The monetary policy is interested chiefly in the capital flows directly connected with the investments. The identification of the balance of payments effects is in this case confined to a comparison of

- the imports of capital for the investment and
- the transfer of profits back to the foreign country in subsequent years.

In some cases payments for royalties, license fees, etc., and estimates of clandestine profit transfers, e. g. through group-internal overpricing by parent or subsidiary, are also taken into account.

2. A significantly different result may be obtained in an investigation designed to establish the micro-economic effects – perhaps analogous to a cost-benefit calculation. In this case it is necessary to consider the imports and exports attributable to the enterprise in the analysed period in addition to the capital flows.

3. Finally, a comprehensive macro-economic assessment must take in all the farther-reaching effects – e. g., on production and employment in upstream and downstream areas, displacement of competitors, etc.

A complex analysis is really required for an assessment of these various effects but in practice all three procedural methods are commonly applied. It is peculiar that the probe into capital flows which has the least evidential value is the most widely used method.

A methodological difficulty in the capital flow analysis is that it is in practice hardly ever possible to relate the capital imports involved in an investment to the sum total of attributable profit transfers. Usually the two flows are for this reason simply compared over a period of several years. This rough and ready method – inflationary effects for instance and the difference between sales- and purchases-oriented investments are completely ignored – leads fairly regularly to the result that the total profit transfers exceed the inflow of direct investment capital into developing countries.

Empirical Results

Bos, Sanders and Secchi calculated the outflow of capital from all developing countries together in the 1965-1969 period at US \$ 10.3 bn; the inflowing capital (incl. reinvested profits) amounted to \$ 11,978 mn and the outflowing profits to \$ 22,256 mn⁹. Matthies arrived for Mexico at a deficit of US \$ 2.5 bn in the period from 1940 to 1975¹⁰. Koopmann put the net outflow from Colombia in 1950-1975 at US \$ 42 mn¹¹, and Bode and Müller-Debus computed for Malaysia a deficit of US \$ 110 mn in 1962-1970¹².

Presuming that these investments would also have been made by domestic investors – and were thus merely a substitute for indigenous investments – the simple capital flow analysis may suggest that foreign direct investments in developing countries should be regarded as a burden on the host countries. UNCTAD studies by Meddlman, Lall, Lacey and Seagrave for Jamaica and Kenya for instance however show that the replacement premise is far from realistic. Nevertheless it has to be noted that the “discovery” by limited means – the methods of flow analysis – of comparatively high capital outflows is one of the major reasons why a negative view is taken of the value of

⁹ Cf. H. C. Bos, M. Sanders, C. Secchi: *Private Foreign Investment in Developing Countries*, Dordrecht-Boston 1974.

¹⁰ This includes licence and management fees. Cf. K. Matthies: *Transnationale Unternehmen in Mexiko (Transnational enterprises in Mexico)*, Hamburg 1977.

¹¹ Cf. G. Koopmann: *Multinationale Unternehmen in Kolumbien (Multinational enterprises in Colombia)*, Hamburg 1978.

¹² Cf. T. Bode, T. E. Müller-Debus: *Die Auswirkungen von Direktinvestitionen auf das wirtschaftliche Wachstum, die Beschäftigung und die Zahlungsbilanz von Malaysia (The effects of direct investments on economic growth, employment and balance of payments of Malaisia)* (diss.), Regensburg 1975.

direct investments in the Third World under development aspects. When other transfer payments and the imports of plant, equipment and other goods are brought into the equation, the result is often even more glaring.

If additional effects associated with the investment are taken into account, the ensuing result is however entirely different. On the realistic assumption that direct investments are capable of replacing at least part of formerly required imports and/or enabling additional exports to be made by virtue of the production now taking place in the country the balance of payments effects are almost the opposite of those suggested by the capital flow analysis. In this case all empirical analyses for the determination of the extent of the financial and goods flows point to substantial positive effects.

On this presupposition of a more additive investment Koopmann arrived for Colombia in 1966-1973 at a figure of US \$ 2.6 bn for import substitution and US \$ 286 mn for increased exports due to foreign investments. This means that if all imported advance inputs, the transfer of profits and royalties and the net capital inflow are taken into account the net benefit to the balance of payments works out at approximately US \$ 2.8 bn¹³.

In Mexico also all deficitary effects are greatly overcompensated by the benefit from import substitution. In 1970 the import substitution by foreign enterprises in the manufacturing industry amounted to over US \$ 1.2 bn or 70 % of the imports of industrial goods into the country¹⁴.

In Malaysia the direct investments are owing to the availability of tin and rubber chiefly export-oriented. For the period of investigations, from 1966 to 1970, the foreign currency benefit due to foreign investments has been calculated at US \$ 3 bn¹⁵.

The gain from US direct investments to the balance of payments of Latin American countries in the years from 1965 to 1968 has been put at about US \$ 8.5 bn a year of which about \$ 4.5 bn are attributed to additional exports and \$ 4.0 bn to substitution of imports¹⁶.

In spite of differing computing methods and difficulties in the collation of data it may thus be stated that the positive effects of foreign investments on the balance of payments by virtue of import substitution and/or export promotion¹⁷ taken as a whole more than compensate for the deficitary transfer effects. This view is shared by the United Nations the studies of

which are based on the work of experts subscribing to various schools of thought. Their verdict is summed up as follows: "When all the direct effects on the balance of payments accounts are taken into consideration, the net result in the developing countries is usually positive"¹⁸.

The actual conditions in the developing countries – especially in the "threshold" countries which have already made greater economic advances – suggest that the assumption, inferred here, that direct investments are entirely additional is in this absolute form unrealistic. The mentioned positive results should be revised downwards according to the percentage rate of actual additional production, import substitution and export expansion. This is however difficult because really plausible and convincing studies about this highly intricate complex of questions do not exist. Because of this one can only say that the undeniably negative effect of profit transfers is mitigated and may be reversed by export expansion and import substitution.

The consequential effects of direct investments have not been taken into consideration in this context. There are only a few estimates available about the balance of payments effects induced by the price and income mechanism and connected adjustment processes in the economy as a whole. Direct investments may for instance become the pivotal point for the establishment and expansion of accessory industries or as big enterprises displace small indigenous business rivals and their accessory suppliers. Here – as in the alternative situation described earlier – the result depends on basically contrary assumptions on the effect of investments.

Choice of Methods

It is clear from what has been said so far that the verdict on direct investments depends in great measure on the alternative position assumed for the analysis and on the magnitude of the effects ascribed

¹³ G. Koopmann: *Multinationale Unternehmen in Kolumbien*, *ibid.*, p. 79 ff.

¹⁴ Cf. K. Matthies: *Transnationale Unternehmen in Mexiko*, *ibid.*, p. 60 ff.

¹⁵ Cf. T. Bode, T. E. Müller-Debus: *Die Auswirkungen . . .*, *ibid.*, p. 160 ff.

¹⁶ Cf. H. K. May: *The Contribution of US-Private Investment to Latin America's Growth*, Report for the Council for Latin America, New York, no indication of date of publication; cf. also H. C. Bos, M. Sanders, C. Secchi, *ibid.*, p. 32 f.

¹⁷ The positive effects are reinforced by the contribution of the direct investments to export diversification.

¹⁸ UN: *Department of Economic and Social Affairs: Multinational Corporations in World Development*, New York 1973, ST/ECA/1960.

to an investment. The apparent incompatibility of inferences drawn from analyses which start from different presuppositions is explained largely by this background.

Another factor is that even if there is agreement on which primary and secondary effects are to be taken into account a variety of methods may be used for ascertaining these effects, and this in turn may lead to relatively widely diverging results. Most common are:

- Models with a macro-economic production function, behavioural assumptions and mostly relatively simple interconnections between selected macro-economic factors: These models have the advantage that they permit computations to be made and thus the effects to be quantified. If enough data are available, it is possible to make comparisons between several countries. On the other hand, they have the drawback that important relations are lost sight of because the models have to be simplified¹⁹.
- Cost-benefit analyses showing individual project results which are aggregated to indicate the overall effect on the economy: Certain problems arise in this case in the choice of the analytical method²⁰ as well as in the evaluation of the factors entering into the computations. Besides, the aggregate of individual effects is not identical with the effect on the economy as secondary and consequential effects are mostly underrepresented in investigations of this kind²¹.
- Descriptive-analytical studies²²: These usually start with an inquiry into the maximum effect assuming the investment is fully additive. This is followed by an attempt to formulate a realistic alternative position as grounds for which it is common practice to advance plausibility considerations and inquiries as well as inferences from relevant secondary data.

To go by the number of studies, the descriptive-analytical method is evidently the most common one at present. Its drawback is the usual lack of quantifiability and the consequent difficulty of comparisons between

several countries. It has the advantage that it comes nearest to allowing for the conditions met in reality. In this respect it seems – like the cost-benefit analysis – to be of superior evidential value compared with the model approaches with their inherent limitations. It requires however particular exactitude and detailed knowledge of the country.

Implications for Economic Policy

The considerable procedural differences in the assessment of foreign investments traced here explain why so many divergent opinions and comments are offered for them. For the results of inquiries depend to a significant degree on the method chosen, the assumed alternative position and the extent of the effects taken into account. When the various propositions are evaluated it is therefore most important to establish how realistic the procedures and assumptions are, especially if certain analyses are to be used as the basis for economic policy measures and decisions.

Once the basic decision in favour of private economic activities and the use of foreign capital – including direct investments – has been taken in a developing country, the extreme assumptions implying that investments are fully substitutional or fully complementary are least likely to prove correct. To what extent indigenous investments are displaced depends on the situation in the individual country, its equipment with physical and human capital, its other resources, the investment sector, the location, the policy in regard to foreign investments and other factors.

The analyses of investment effects which allow at least in part for these factors lead uniformly to the result that it is inadmissible to speak ever of generally or exclusively positive or negative effects on the host country. The government of the host country has considerable influence on the effects of an investment on the achievement of development policy objectives. It is within the competence of the developing countries to set adequate conditions for the realization of their economic and social ideas. It is for them to decide to what extent management methods of a market-economy type are to be preferred to dirigiste control mechanisms. The power to influence foreign investments lies in the main with the governments of the developing countries themselves. The legislation of the countries of origin and the directives on conduct by international organizations are only of a supportive nature.

¹⁹ Cf. H. C. Bos, M. Sanders, C. Secchi: Private Foreign Investment in Developing Countries, *ibid.*, p. 53 ff.

²⁰ A distinction has to be made in this respect in particular between the Little-Mirrless method, usually applied by the World Bank, and the UNIDO's approach. Cf. G. B. Baldwin: A layman's Guide to Little-Mirrless, in: Finance and Development, 9th year, March 1972, p. 16 ff.

²¹ Such investigations are made by UNCTAD for several countries. Cf. UNCTAD, Trade and Development Board, Balance of Payments and Income Effects of Private Foreign Investment in Manufacturing, (a) Case Studies of India and Iran, TD/B/C, 3 (V) Misc, 1, Dec. 1971, (b) Case Studies of Colombia and Malaysia, TB/B/C, 3 (VI) Misc, 1, July 1973.

²² Among these are the mentioned studies by Koopmann, Matthies and Bode, Müller-Debus.