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New Forms of Foreign Investment in Developing Countries

Determinant Features, Characteristics and Prospects

by Werner Olle, Berlin*

To a growing extent, since the early 1970s "new forms" of foreign investment have developed which constitute a departure from full ownership of the capital by the foreign investor and the practice of "packaged" management services. What view is to be taken of these new forms of investment from the development policy aspect?

The present circumstances of foreign direct investment have become much more differentiated throughout the world than at the end of the 1960s. Since that period

- considerable shifts have occurred between the dominant industrialised nations with regard to their comparative importance as investors and as countries receiving direct investment;
- new key areas of investment have grown up in the developing countries (especially in South-East Asia) and firms from developing countries (especially from India, South Korea, Taiwan and Brazil) have come forward as entirely new agents for investment activities abroad;
- even the state-trading nations (such as recently the People's Republic of China and Cuba) from which foreign investors were formerly excluded are now open to direct investment by foreign firms;
- the potential range of operations, sectors and products for foreign investment has been extended;
- the form of market access for foreign investors who are increasingly resorting to take-overs of existing firms (especially in the case of direct investments in industrialised nations) is changing;
- the funding structure of foreign direct investment is being modified in that there is more recourse taken to the capital resources of foreign subsidiaries and borrowings which are mobilised on the local capital markets and on the international capital markets which expanded rapidly during the 1970s.

* Forschungsstelle Sozialökonomik der Arbeit. – This paper is based upon the results of a comprehensive study carried out by the author and which has been published under the title "Strukturveränderungen der internationalen Direktinvestitionen und inländischer Arbeitsmarkt" as Vol. 6, in: Beiträge zur Sozialökonomik der Arbeit (Minerva-Verlag, Munich).

Yet perhaps the most significant change has been occasioned by the emergence of new forms of foreign investment in developing nations which, in principle, not only call into question the traditional *concept* of direct investment (and thus its statistical coverage) but may possibly also help to reduce or remedy the negative *effects* which, in some cases, were suffered by developing countries as a result of direct investment by foreign firms.

General Characteristics

The primary structural feature of new forms of foreign investment in developing countries and the diverse forms they may take in practice are indicated by an opinion of the OECD Development Assistance Committee which stated in its annual report for 1980: "To a growing extent 'new forms' of foreign investment have developed since the early 1970s which constitute a departure from full foreign ownership of the investment venture and the practice of 'packaged' technology. These often comprise a spectrum of complex pragmatic and *ad hoc* arrangements to suit the particular situation. They include joint ventures; minority participations; production-sharing and sub-contracting agreements; management, technology, licensing and marketing contracts; phase-out agreements; turnkey projects; buy-back, cofinancing and trilateral financing arrangements. Increasingly also, the distinction between foreign direct investment, non-equity investment, inter-company transfers and foreign trade is becoming blurred."¹

While traditional direct investment was based upon a complete or at least a majority ownership of the capital by the foreign investors, new forms of foreign

¹ Development Assistance Committee: Development Cooperation 1980, Paris 1981, p. 164.

investment are distinguished by the fact that they can be applied without ownership of the capital by the foreign firms or at least with a markedly reduced formal ownership. In theory, they give the developing countries the opportunity considerably to curtail the influence of foreign firms upon their economic development.

While traditional direct investment represented an *integrated unit* of formal equity holdings and management, organisational and technological know-how, the new forms of foreign investment imply that that unit can be broken down into *separate* economic transactions and that they can be carried out with *different* firms from industrialised nations. In theory, they give the developing countries the opportunity to increase their influence when cooperating with firms from industrialised nations so that, for example, investment projects can be more suitably aligned with the economic plans of the country in question, the financial terms improved or the follow-up costs reduced and the skills of the indigenous labour force and the transfer of technology can be more effectively organised.²

Service Contracts in the Raw Materials Sector

New forms of foreign investment developed first of all in the economic sector which has traditionally been the prime area for foreign direct investment in developing countries: the raw materials sector. Essentially, this change was initiated by the developing countries themselves – and for a good reason. Traditional direct investment in the raw materials sector guaranteed the foreign investor extensive and exclusive rights to exploit all the raw materials in a specific territory; the developing country usually received only very modest proceeds from leases and taxes. The direct investment statistics themselves could not conceal the fact that the developing countries have always been *exporters* of capital in the raw materials sector because the profits which the foreign firms repatriated to the industrialised nations were considerably in excess of the inflows of capital for foreign direct investments. Thus, according to UNCTAD, in 47 surveyed developing countries the outflow of capital *from* those countries was 2.5 to 4 times

as great as the capital inflows for direct investment between 1968 and 1973.³

Since the end of the 1960s and increasingly since the mid-1970s a process has become perceptible in the developing countries' raw materials sector in the course of which the influence of foreign firms, based upon formal legal titles, has been restricted. Former concessions which were to be valid for decades have been cancelled by the developing countries and renegotiated; the terms governing profit-sharing between the host country and the foreign investor are being revised or (in many cases) formulated for the first time; existing subsidiaries of foreign investors are being gradually converted into joint ventures with indigenous majority holdings; in some sectors and countries of investment foreign firms are being nationalised; new investment projects are in most cases permitted only on condition that the foreign investors have merely a minority or even no equity holding.

The mineral oil sector can be cited as a particular example to show how quickly this process advanced during the 1970s. In 1970 the share of oil production held by the OPEC nations' governments was only 2.3 %(!) but even by the mid-1970s it had increased to 75 %.⁴ Examination of the structure of supplies to the 7 largest oil companies (Exxon, Mobil, Texaco, Socal/Chevron, Gulf, Shell, BP) yields a similar result: in 1973 82 % of their supplies of crude oil from developing nations came from firms in which those companies had a formal share of the equity. By 1978 this percentage had dropped to 42.1 %, reducing to 25.6 % in 1980 and 17.5 % in 1981.⁵

Regardless of this increased formal power of control, however, the developing countries still remained dependent upon cooperation with foreign firms in essential functional areas, such as financing, technology, management and marketing. While only a minority holding or no holding at all was allowed, this cooperation had to be assured by *contract* (through "service contracts") and offered on conditions which were profitable for the foreign firms too.

Service contracts usually stipulate that the foreign investor acquires no or only a small formal title (e.g. to oil-fields, mines, plant) but instead operates as a contractor for a national firm or a state institution of the developing country in question. The foreign investor generally provides equipment, technology and management and finances the exploration and operating costs (or at least those incurred in foreign

² For information on the recently initiated debate about new forms of foreign investment see, for example, Charles Oman: The "New Forms" of Investment in Developing Countries: a state-of-the-art, OECD Development Centre, Working Document CD/R (80) 1314, Paris 1980, and Christian Pollak: Neue Formen internationaler Unternehmenszusammenarbeit ohne Kapitalbeteiligung, Munich 1982.

³ Cited by Peter Richter: Der Kapitaltransfer in die unterentwickelten Länder, West-Berlin 1979, Tables 21 and 22, p. 170.

⁴ Anton Gälli: Die sozio-ökonomische Entwicklung der OPEC-Staaten, quoted by Christian Pollak, op. cit., p. 15.

⁵ Jochen H. Mohnfeld: World Oil Markets – Implications of Structural Change, in: Petroleum Economist No. 7/1982, p. 270.

currency). In return for providing those funds and services the foreign firm receives either specific payments or – more commonly – contractually established compensation from the current production. The following facts can be used to illustrate the extent of such agreements:

- ☐ In the case of compensation agreements (sometimes in the form of production-sharing) up to 40-60 % of the total output is placed at the foreign investor's disposal for a contractual period of 15-25 years.
- ☐ Financial regulations cover all the sub-areas of the foreign investor's entrepreneurial activities. For example, an agreement between the Zambian Government and the Anglo-American Company stipulates that AAC is to receive separate payments for the following services: (a) management, consultancy and technology; (b) marketing the products; (c)

purchasing the necessary equipment; (d) engineering. In view of this type of agreement some observers conclude that, by acting as contractors, foreign firms may on occasion obtain considerably higher earnings than those formerly achieved through direct investment.⁶

Service contracts do, however, represent more than a straightforward agreement on the provision of services by a foreign investor and the corresponding payment conditions. They also mean that the foreign contractor is granted two important areas of competence: the *management* of the investment project (with all the pertinent individual powers over finance, administration and personnel) and the *marketing* of the output mainly through exports.

A typical management agreement (e.g. the "Partnership Agreement" between the Jamaican Government and Kaiser Aluminium and Chemical Corporation) grants the foreign investor the following powers:

- ☐ all operational control concerning plant and equipment,
- ☐ the appointment and dismissal of personnel,

⁶ Cf. Samuel K. B. Asante: Restructuring Mineral Agreements, in: American Journal of International Law, Vol. 73/No. 3, July 1979; Sandro Sideri, Sheridan Johns (eds.): Mining for Development in the Third World, New York 1980; Thomas W. Wäldle: Evolution of Transnational Mineral Development, in: Development and Peace, Vol. 2/Autumn 1981.

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

New Publication

Klaus Bolz (Ed.)

DIE WIRTSCHAFTLICHE ENTWICKLUNG IN AUSGEWÄHLTEN SOZIALISTISCHEN LÄNDERN OSTEUROPAS ZUR JAHRESWENDE 1982/83

**(ECONOMIC DEVELOPMENT IN SELECTED EAST EUROPEAN SOCIALIST COUNTRIES
AT THE TURN OF THE YEAR 1982/83)**

For eleven years now, at the beginning of each year, the Department of Socialist Countries and East-West Economic Relations of the HWWA-Institute has prepared a survey of the economic results of the preceding year and of trends in the current year for individual CMEA-countries. The 11th report also draws a comparison with the guidelines for the medium-term development of the respective countries, as laid down in the Five Year Plan (1981-1985), and assesses the chances of important Five Year Plan targets being achieved. (In German.)

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- ☐ the issue of sub-contracts to outside firms, including the pertinent financial agreements,
- ☐ the budget planning for the investment project in question.⁷

Although mention should be made of a considerable number of gradations between, for example, the mineral oil and mining sectors and also between individual developing countries, service contracts of the type described above do give reason to conclude that, while *formally* distinct from the traditional kind of direct investment, they do nevertheless retain some essential elements of those investments as regards their specific economic features (i.e. the actual power of control).

International Subcontracting

The tendency to dissociate formal ownership from the actual economic power of control also appeared in the manufacturing industry as the 1970s progressed. Internal production in the foreign firm's subsidiaries, which was characteristic of the traditional direct investment, is increasingly being replaced by controlled production in outside, formally independent firms in the developing countries.⁸ An essential feature of this new investment strategy of foreign firms in developing countries is that it can be implemented by the foreign firm with considerably less capital expenditure (and often without any investment at all) while still giving it power of control over the local production capacities and labour force.

From the point of view of the local producer, controlled outside production always involves a *diverted demand* because the produced goods can be realised only through a contract with the foreign firm in question. This situation causes both the economic power of control of the foreign firm and the dependent position of the local producer.

The foreign firm's influence is generally acquired because it

- ☐ determines all the production standards (e.g. by technical specifications or by providing specific equipment);
- ☐ controls the course of production (whether directly by attaching representatives of the foreign firm or by in-works quality controls); and

- ☐ has the sole competence for marketing the products (in the case of production of specific components this dependency is usually technically predetermined while in the case of finished products, they are marketed under the foreign firm's trade name).

Further dependencies of the local firm in a developing country result from the fact that

- ☐ it produces mainly for only a few customers (for example, the majority of the contractors in the clothing industry in Haiti have only one foreign customer);⁹
- ☐ certain types of contract are characterised by an extreme level of instability (especially if a temporary surplus demand for capacity in the foreign firm results in orders being given to local producers in a developing country and these are then terminated when the order situation reverts to normal);
- ☐ uncertainties exist in the contract (e.g. in contracts which have not been set down in writing);
- ☐ and, last but not least, the foreign firm alone decides whether to terminate or continue an existing agreement.

These revised investment strategies have acquired practical importance initially in the two industries to which the developing countries' expansion of exports in the industrial goods field can be essentially attributed: the clothing industry and certain electrical/electronic production lines (especially entertainment electronics).

Both examples – the clothing industry and entertainment electronics – indicate that new forms of foreign investment in the developing countries' industrial sectors are applied precisely when the following conditions obtain:

- ☐ strong competition among locations (even within the region of the developing countries),
- ☐ comparatively small economies of scale (e.g. by frequent changes of fashion or designs), and
- ☐ little need for technical integration.

Apart from the examples mentioned above, since the end of the 1970s the spectrum of industries in which the new investment strategies of foreign firms are applied has begun to expand. As a number of more recent instances show (e.g. Volkswagen's production under contract in Spain and India) new forms of foreign investment are likely to replace the traditional direct investment to a growing extent also in the motor vehicle industry and its ancillary industries.

⁷ Cited in Samuel K. B. Asante, *op. cit.*, p. 109.

⁸ Cf., for example, Susumu Watanabe: International Subcontracting and Skill Promotion, in: *International Labour Review*, No. 5/May 1972; Michael Sharpston: International Subcontracting, in: *World Development*, No. 4/1976; Claudio Jedlicki, Mario Lanzarotti: *Sous-Traitance Internationale – Quelle Industrialisation?*, in: *Revue Tiers-Monde*, No. 81/ janvier-mars 1980.

⁹ Jean-Robert Estimé: *International Subcontracting – The case of Haiti*. Paper presented at the International Meeting on "International Subcontracting", Port-au-Prince, 29. 11. - 1. 12. 1978, p. 28.

Turnkey Contracts

A third trend towards new forms of foreign investment can at present be observed with regard to exports of plant from industrialised nations for which the conditions have changed considerably over the years.

Economic development during the latter half of the 1970s was characterised by economic stagnation in the traditional industrialised nations and by rapid industrialisation of the "newly industrialising countries". This combination of circumstances intensified competition between the industrialised nations while, at the same time, opening up new markets and locational potential. In major export industries of the industrialised nations (such as plant construction) this trend is reflected in the fact that during the 1970s the developing countries accounted for an increasing proportion of the volume of orders received by firms in the industrialised nations; but those firms were also compelled to offer comparatively favourable conditions.

For purchases under *turnkey contracts* the average period now allowed for payment is 10 years; the interest rates offered are in some cases well below the market level; methods of payment are quoted which take advantage of state-subsidised mixed financing (e.g. by export credits), etc. At the same time, the firms constructing the plant have to provide a range of services far wider than the one offered previously. The competition on the more constricted foreign markets requires that the plant exporter

- ☐ secures all the finance for the project,
- ☐ guarantees the training required for the indigenous labour force,
- ☐ assumes management functions for a number of years even after the plant has been put into operation, and
- ☐ organises the marketing of the products on the export markets.¹⁰

This expansion of the range of functions assumed by the foreign suppliers of the plant often results in a different relationship between the firms involved. This occurs particularly in three instances:

- ☐ In view of the operational and financial risks involved in turnkey contracts, when concluding those contracts

the developing countries themselves sometimes insist that the suppliers of the plant take a direct small share in the capital of the pertinent investment project.

☐ Much more frequently, however, contractual arrangements which do not involve a formal capital holding by the suppliers do in practice perform the same function – reducing the financial burden and operating risks of the purchasing country. First of all, the contracts may be drawn up in such a way as to impose the smallest possible strain upon the purchasing countries' foreign exchange reserves. One of the possible forms of non-monetary compensation for the goods and services provided by the suppliers of the plant is the "buy-back arrangement" which usually covers more than purely commercial relations. If payment from current output is agreed under the buy-back arrangement, the supplier will still be directly interested in ensuring the product's quality, compliance with the technical specifications, the marketing arrangements, etc., even after the investment project has been implemented and will give expression to that interest by means of supplementary agreements (e.g. management contracts). In this way, however, not only is the foreign firm the supplier of the plant and the purchaser of the output but to a certain extent – depending upon whether the management powers comprise individual operational functions or the entire management – it also acquires a direct influence over the business activities of the enterprise in question.

☐ Finally, the same contractual arrangements may also result from the plant manufacturer's weighing-up of locational factors. This applies particularly to exports of plant to the "newly industrialising countries" if they have locational advantages for the production of specific components and/or specific products for the relevant engineering sector.

Regardless of whether in any individual case this form of contract results from the requirements of the developing country or the foreign firm's consideration of locational factors, it does in the final analysis mean that an erstwhile purely commercial transaction is increasingly evolving into a new form of foreign investment. German plant manufacturers define this process as follows: "The available engineering work is being expanded, more services are being provided and in-firm production is on the decline. Foreign sources of supply are being tapped to a growing extent; in other words, the trend towards multinational industrial plant business is being intensified."¹¹

¹⁰ Cf. Werner Hans Engelhardt: Grundlagen des Anlagen-Marketings, in: Schmalenbachs Zeitschrift für betriebswirtschaftliche Forschung, Sonderheft 7/1977; Otmar Franz: Dienstleistungen im internationalen Anlagengeschäft, in: Schmalenbachs Zeitschrift für betriebswirtschaftliche Forschung, No. 5/1982; Wolfgang Reeder: Exportfinanzierung im Anlagenbau, in: Zeitschrift für Betriebswirtschaft, No. 1/1982.

¹¹ Norbert König: Ausgeprägte Multinationalität im Anlagenbau, in: Die Bank – Zeitschrift für Bankpolitik und Bankpraxis, No. 4/1982, p. 165.

Any analysis of new forms of foreign investment in developing countries must, however, mention that these are by no means an irreversible trend. Over the last few years, in fact, the mining sector has been showing an increasing number of indications that a "second coming" of the traditional form of direct investment cannot be ruled out.

Opposing Trends

These opposing trends are indeed closely linked with the new forms of foreign investment which – precisely in the mining sector – have one major consequence for the developing countries: the demand for a rearrangement of investment funding. On the one hand, new forms of foreign investment have resulted in a considerable reduction of the direct financial contributions of foreign mining companies while, on the other hand, the capital expenditure required for mining projects increased enormously during the 1970s (according to the Rio Tinto Zinc Corporation, for example, the capital expenditure required before a copper mine is operational rose from \$ 200-400 million in the early 1970s to its present level of \$ 1.5-2 bn).¹²

The developing countries cannot usually supply these additional funds from their own resources because mineral raw materials do not provide the foreign exchange earnings needed for financing investments. So they have to mobilise those funds from external sources; either by borrowing from abroad (especially on the Eurodollar market) or by recourse to foreign equity participation. This exigency has different consequences:

□ On the one hand, the lending banks in the industrialised nations are increasingly demanding that firms from those nations should again take a larger formal holding in mining projects of present-day dimensions.

□ On the other hand, it has been noticeable for some years that the oil groups in particular are diversifying their capital holdings and are increasingly moving into the mining sector. As the examples of Standard Oil (in Zaire, Zambia and Indonesia), Shell (in Peru) and Exxon (in Chile) show, this process has become particularly

¹² Philipp C. F. Crowson: Mineral development, financing and cooperation, in: Resources Policy, Vol. 8/No. 2, June 1982, p. 123.

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

New Publication

Peter Plötz/Raimar Richert

DDR-TRANSIT ÜBER HAMBURG

- Situation, Bestimmungsgründe, Perspektiven des Seetransitverkehrs der DDR
über den Hamburger Hafen -

(GDR TRANSIT VIA HAMBURG - Situation, Determinants and Prospects of the GDR's Seaborne
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The present study analyses the development of the transit traffic of the GDR as well as the latter's reasons for using the facilities of the port of Hamburg to such an extent that, in terms of its importance as a seaport to the GDR, it gained the second rank after Rostock. The study which also deals with the efficiency of the GDR's own ports tries to find an answer to the question as to the future use by the GDR of the port of Hamburg. (In German.)

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evident in the copper mining sector. The first indications of this trend can also be perceived in nickel production (such as the equity holding of Billiton Overseas, a Shell subsidiary, in the Cerromatoso mining complex in Columbia).

Assessment of New Forms of Investment

This brief survey of new forms of foreign investment in various areas of application clearly shows that their positive effects which may be demonstrable in theory and desirable from the point of view of development policy have by no means been achieved. This applies particularly to service contracts in the mining sector and the forms of dependent production under contract in sub-areas of the manufacturing industry.

In the mining sector service contracts have not usually resulted in the developing countries acquiring a greater say in the decisions. Indeed, as well as continuing dependencies with regard to technology, management and marketing, their reliance upon external funds has escalated even further as a consequence of new forms of foreign investment. The switch from funding by foreign equity capital to funding by credits not only represents a difference in structure but also usually implies a considerably heavier financial burden. These circumstances do to some extent explain the recent phenomenon whereby it is precisely the raw material rich developing countries which have incurred the heaviest foreign indebtedness.¹³

Forms of dependent production under contract in labour-intensive sub-areas of the manufacturing industry which are dependent upon exports can neither guarantee permanent employment and earnings facilities for the large majority of developing countries nor effect a transfer of technological know-how to them. The former is essentially restricted by the dependence on the industrialised nations' markets and the competition between the developing countries while the latter is impeded by the fact that this type of production under contract is often no more than the manufacture of sub-units which is also characterized by standardised technologies and little demand for higher skills. Only a few developing countries have so far managed by means of a properly oriented industrialisation policy to organise international sub-contracting in such a way as to permit expansion and diversification of their industrial base or successful imitation with autonomous export potential (two examples are the electronics industries of South Korea and Taiwan).

On the other hand, service contracts in the mineral oil sector and new forms of foreign investment for plant construction must be rated quite differently.

In the mineral oil sector the developing countries have undoubtedly succeeded in concluding service contracts in such a form that the foreign firms' decision-making power has been considerably curtailed. Although foreign contractors still have operational powers and organise marketing on the foreign markets, the developing countries are responsible for essential fundamental decisions, such as the volumes to be extracted and the sales prices. The *effect* of this expansion of competence could be weakened only if – and the first indications can already be observed – a critical change occurs in the general external conditions (e.g. by a further drop in demand, partial substitution resulting from alternative locations in the industrialised nations or alternative sources of energy or by a decreasing ability to achieve a consensus in the existing producers' cartel).

The development of new forms of foreign investment in the plant construction sector does initially provide a number of positive effects. For example, the follow-up costs of major industrial projects can be considerably reduced, the skills of the indigenous labour force improved, access to foreign technology and its adaptation to local conditions facilitated and, with suitable agreements on compensation, the burden on the balance of payments can be lessened. Yet those positive effects would be curtailed if, on the one hand, turnkey contracts lead to surplus capacities in the developing countries (examples are shipbuilding in South Korea or the steel industry in Brazil) and, on the other hand, the industrialised nations' imports were increased in structurally weak sectors of production.

This assessment which differs according to the various areas of application does permit one general conclusion: essentially, positive effects of new forms of foreign investment occur only when the economic sectors in question operate under comparatively favourable general external conditions. These may be based upon the economic positions of the developing countries (mineral oil sector) and on the economic conditions of the industrialised nations (plant construction). If this requirement is not fulfilled or only inadequately met (e.g. in the case of service contracts in the mining sector and production under contract in certain sub-areas of the manufacturing industry), new forms of foreign investment can have only a limited corrective effect.

¹³ Cf. for example, Jeffrey A. Katz: Capital Flows and Developing Country Debt, World Bank Staff Working Paper No. 352, Washington August 1979.