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Foreign Investment and Domestic Development: Multinationals and the State

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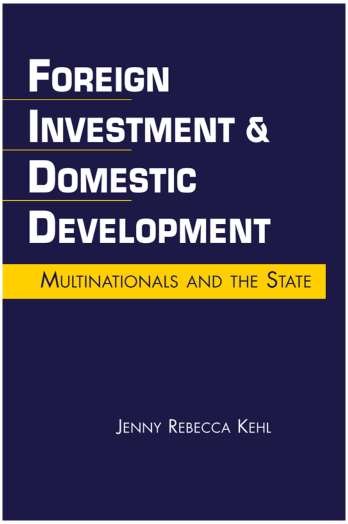

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Introduction: The Political Economy of Development

THE DEVELOPING WORLD RELIES ON GLOBAL markets to stimulate growth and generate wealth. Yet, in this time of great global opulence, trillions of dollars flow through the developing world without altering its reality of poverty and scarcity. At the turn of the century, the world's fifty largest foreign investors in the developing world held $1.8 trillion in foreign assets and $2.1 trillion in sales.[1] Amartya Sen, Nobel laureate in economic sciences, contrasts this unprecedented amount of wealth in the international economy with the "remarkable deprivation, destitution and oppression" observed in most of the world.[2] There is a growing discrepancy between the substantial foreign investment in the developing world and the sparse resources available for domestic development. The global market alone has failed to reverse this trend. However, the size of the global economy is expected to quadruple in the next fifty years, with the majority of the growth in foreign direct investment (FDI). This growth has the potential to increase the financial and capital resources available to promote development in poor countries. The expansion of FDI offers developing countries the opportunity to increase their integration into the global market and to develop investment patterns that maximize their possibilities for economic growth.

In this book I examine the crucial relationship between foreign direct investment and domestic economic development. Foreign direct investment can be an asset to developing countries by providing employment, capital, revenue, trade, and technology. Most underdeveloped countries, however, lack the institutional capacity to negotiate mutually beneficial investment arrangements with multinational corporations. Weak political institutions and perverse economic policies make developing countries easily exploitable. Nevertheless, as this study demonstrates, developing countries can in fact gain greater benefits from hosting foreign investment, without deterring future investment.

The essential strategies for gaining greater benefits from foreign investment are political, not economic. Political institutions mediate the conflict of interest and the disparity of power between multinational corporations and host governments in order to maximize benefits and minimize externalities. In the chapters that follow, I provide cross-national evidence that domestic benefits from foreign investment are contingent on government capacity, democratic accountability, regulatory standardization, and development policies that maximize freedom of production and consumption. I also compare the distinct investment arrangements of General Motors Corporation, one of the world's largest foreign direct investors, in Mexico, India, Nigeria, Kenya, Chile, and Malaysia. This innovative multimethod approach exposes the negotiation strategies of host governments and General Motors, and provides a much-needed assessment of the outcomes of investment arrangements for developing countries and multinational corporations.

Not all developing countries have been able to benefit from the promise and prosperity of foreign investment. Poor countries cannot rely on the altruistic intentions of foreign investors to promote domestic development. Most multinational corporations are more highly organized and have more money than the countries in which they invest. This gives them leverage to negotiate lucrative, and often exploitative, deals with fledgling governments in poor countries. There is an important ongoing narrative about how foreign investment leads to exploitation. But that is not the narrative of this research. My purpose is to demonstrate how developing countries can manage foreign investment to promote domestic development.

The benefits and externalities of hosting FDI are largely a function of how well governments negotiate initial investment arrangements. Accordingly, I address the following questions: What specific strategies are successful in negotiating mutually beneficial investment arrangements between countries and corporations with asymmetrical bargaining power? Are there discernible differences in domestic political institutions and economic policies that generate distinct patterns of foreign direct investment? What determines the success or failure of developing countries to utilize foreign investment to promote domestic development? Previous research has focused almost exclusively on how to attract foreign investment. This study focuses on how to utilize it.

The Role of Political Institutions

Political institutions provide incentives and impose constraints on foreign investment. Governments rely on institutions to resolve political problems, coordinate economic activities, and implement strategies to promote development. In the case of foreign investment, the capacity of developing countries to negotiate mutually beneficial investment agreements is contingent on the ability of political institutions to achieve specified goals.[3] Political institutions must be able to manage resources, react to political and economic challenges, predict and prevent crises, and achieve policy results.

The World Bank's *Global Development Finance Report* suggests that good policies and good governance, along with strong institutions, are critical to using private foreign investment inflows productively.[4] When governments decide to host foreign investment as part of an economic development strategy, political institutions often determine the success or failure to maximize domestic benefits and minimize negative externalities. Political institutions moderate competing interests, mediate asymmetrical power, develop codes of conduct, and specify the rights and responsibilities of foreign corporations and host governments.

Recognizing the explanatory value of political institutions challenges the alternative explanation of economic determinism. The relationship between foreign direct investment and domestic development cannot be explained entirely by economic variables. Chapter 2 elaborates on the alternative economic explanations. However, as Frances Hagopian and Samuel Huntington argue, "economic forces are indeterminant [*sic*]; their influence on outcomes must be filtered through political institutions."[5] The political institutional framework suggests that institutions are central to good economic governance. Governments develop institutions to raise revenue and stimulate economic growth in response to political and economic interests.[6] To satisfy these interests, institutions have become "larger, considerably more complex and resourceful, and *prima facie* more important,"[7] particularly in developing countries. There is, however, wide variation in the capacity of governments to establish effective institutions to meet political demands and economic needs in the developing world. In this study I analyze several indicative political variables—including regime type, accountability, transparency, political stability (political risk), regulation of production practices, performance requirements, and government effectiveness—in order to determine what specific institutional arrangements are successful at achieving good economic governance in developing countries.

The Role of Political Economy

The political economy approach argues that development is driven by a combination of market mechanisms and government decisions. On a spectrum from laissez-faire to command economies, governments often make deliberate political decisions for economic reasons.[8] Government policies may have calculated effects on the market through rules of commerce, fiscal policy, regulation, taxation, expenditure, production, and consumption. I examine these economic indicators in Chapter 2, in accordance with the new institutional economics theory established by Douglass North, Ronald Coase, and Robert Fogel.[9] This theory suggests that it is the underlying institutional framework that determines the success or failure of efforts to establish market-oriented strategies that promote economic growth.

In the case of using foreign investment as part of a development strategy, governments may choose to intervene in production or consumption in order to maximize the profitability of the investment. The liberal theory of political economy suggests that governments must determine their level of intervention in the economy based on the consequences for the market. Pure laissez-faire liberalism advocates a minimal level of government intervention in the economy. However, most political economy theories of development acknowledge that the state is clearly a key actor for countries in the developing stages.[10]

The political economy framework suggests that governments intervene, minimally, in market systems to provide an environment that is conducive to economic growth, to arbitrate between government policy goals and those of individuals and firms,[11] and to compensate those adversely affected.[12] Political economy theory parallels political institutional theory regarding the "coordination" of market forces. However, political economy emphasizes the importance of factors such as market access, market size, trade practices, taxation, and the level of intervention in market forces, while the political institutional approach focuses on variables such as institutional accountability, political stability, government capacity, and policy implementation. The political economy framework advocates for economic neoliberalism as the guiding principle for coordinating market forces. Although neoliberalism has been hotly debated at the theoretical level, the evidence in support of free trade is almost undisputed in the industrialized countries. The picture in the developing countries, however, is quite different. As political economist A. F. K. Organski argues, the poorer the country, the more important are political factors.[13]

A Mixed Reception for Foreign Investment

Foreign investors receive a wide variety of receptions in developing countries. India is an emerging economy that welcomes foreign investors into government-financed High Tech City buildings that are designed to impress modern multinational corporations. These buildings have backup energy sources to compensate for the regular power outages in India, as well as emergency flight plans to transport employees to the nearest High Tech City if their computer systems collapse. The facilities allow foreign investors to conduct business without disruptions in energy supplies or computer communications, which is a luxury that most domestic businesses do not have. Foreign companies have been highly successful in High Tech City locations in India. For example, General Motors has orchestrated the Chevrolet Indian Revolution, "a love affair with the Chevy"[14] that has generated hundreds of millions in revenue. This illustrates a warm reception for foreign investors from the Indian government and consumers. But not everyone shares the love affair with foreign investors. The train bombings in Mumbai in 2006 specifically targeted business commuters on their way to work in modern High Tech City locations for foreign firms such as IBM, Nestlé, Nokia, and General Electric.

Malaysia has developed technology corridors, similar to India's High Tech City buildings, and Mexico has designated maquiladora zones as free enterprise zones to welcome foreign investors. Multinational corporations often receive tax breaks, corporate subsidies, labor concessions, toxic-emission exemptions, and other incentives to conduct business in technology corridors and maquiladora zones. However, political officials and business leaders in both countries have accused foreign investors of creating expensive externalities and failing to honor their initial contracts. In Mexico the outcomes of these disputes are determined largely by the North American Free Trade Agreement, which favors the foreign firms. In Malaysia the central bureaucracy normally governs over foreign investment, but the bureaucracy's power is limited in free enterprise zones. Similar arrangements exist in free enterprise zones worldwide to maximize the freedom of production and consumption for multinational corporations.

Even with free enterprise zones, African countries have had trouble marketing their economies as destinations for FDI. They have been scrambling to receive foreign investors and have undercut each other in a race to the bottom—promising to minimize benefits for the host country in order to maximize profits for the foreign investors. Many African countries agree to forego tax revenue; allow profits to be repatriated rather than reinvested; give away resource rights, mining rights, drilling rights, and valuable raw materials; and absorb the cost of negative externalities in order to attract foreign investors. Despite these concessions, there are sectors that gain benefits from hosting foreign investment, such as oil in Nigeria, agriculture in Kenya, and manufacturing in South Africa. Although the relationship between foreign investment and domestic development is tenuous throughout the continent, African countries continue to welcome foreign investors because they need the capital, employment, technology, and revenue that those investors generate. It is unrealistic and counterproductive to discourage African countries from receiving foreign investment as part of a development strategy. It is more productive to examine a variety of strategies that poor countries can use to improve their investment arrangements by maximizing benefits and minimizing negative externalities.

Organization of the Book

This book is designed to demonstrate how developing countries can manage foreign investment to promote domestic economic growth. “The Politics of Profit: Foreign Investment as a Development Strategy,” Chapter 2, examines the political institutions and economic policies that affect the benefits and externalities from hosting foreign direct investment. Here I examine FDI arrangements using a cross-national analysis of 147 developing countries across 35 years (1971–2006). I test the significance of three competing explanations—political institutional, political economy, and a synergistic model—and examine globalization, diffusion, and the learning process across states. The dynamics of diffusion and the causal mechanisms of change are illustrated in the case studies of Kenya, Nigeria, India, Malaysia, Chile, and Mexico.

Chapter 3, “Road Blocks: Ineffective Bureaucracies in Kenya,” and Chapter 4, “Corruption: Impeding Pioneer Industries in Nigeria,” analyze the consequences of weak political institutions and inconsistent economic reforms in the African region. The case of Kenya demonstrates how ineffective bureaucracy and political instability can result in divestment, while the Nigerian case exposes the debilitating effects of corruption.

Chapter 5, "Growing Pains: Securing the Benefits of High Tech Investment in India," and Chapter 6, "Joint Ventures: Developing a Business Class in Malaysia," demonstrate how institutional capacity has expedited the process of foreign investment and domestic development. India's arrangements with General Motors reveal successful strategies for attracting and utilizing foreign investment to achieve rapid economic growth, despite contradictions between a large labor pool and a small tax base, as well as hidden costs of increasing inequality. The case of Malaysia's contracts with General Motors illustrates the impact of centralized government on investment arrangements, which has allowed Malaysia to enforce requirements on employment and technology transfer.

Chapter 7, "*Adelante*: Government Commitments to Reduce Investment Risk in Chile," and Chapter 8, "After NAFTA: Attracting Multinationals with Free Enterprise Zones in Mexico," focus on the importance of reducing political risk and the dynamics of foreign direct investment in Latin America. They also correct several of the inaccurate myths about what foreign investors consider to be compelling incentives and constraints. Mexico's arrangements with General Motors also highlight the effects of superstructures on the relationship between foreign investment and domestic development, showing how the North American Free Trade Agreement has determined most of the interregional incentives and constraints for foreign investment.

The concluding chapter of the book, "Looking Forward: The Trajectory of Foreign Investment and Domestic Development," provides a synopsis of the research and offers projections about the modernization of investment negotiations and development strategies. The research findings demonstrate that the quality of the investment environment, rather than the quantity of investment, determines profitability for both investors and host countries. The findings also highlight the discernible differences in political institutions that result in distinct patterns of investment.

Notes

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