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Article

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Optimising Foreign Investments

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Discussion about the positive and negative effects of foreign private investment has been going on for years. In the opinion of the authors, the varying benefits and costs of foreign investments to a host country suggest specific policies to optimise their mix.

A dichotomy of views exist as regards the net worth to developing countries of inward foreign investment. On the one hand, there is the view that foreign private enterprise is a first class instrument for the transmission and use of new forms of technology, organisation and efficient exploitation of markets. On the other hand, there is the assertion that private foreign capital creates a neo-colonialist stranglehold on a developing country, limiting its government's freedom of action, introducing inappropiate labour displacing technology, and imposing a serious and mounting strain on the balance of payments as a result of high servicing costs. Support for this view is sought by reference to data published each year by the US Department of Commerce in its "Survey of Current Business" (Table 1). British data show only a slight difference. However, little economic expertise is required to appreciate that this use of figures is myopic and that analysis needs to be undertaken within a more comprehensive framework. Such an analysis is also useful in suggesting measures to optimise the foreign investment mix (Table 2).

In the short-run, foreign direct investment generally is likely to result in an increase in imports of capital goods. There is also likely to be a rise in imports of materials and components in the early years, later declining as local sources of supply and integrated manufacturing processes are established. Where there is local substitution for end-products, the net effect over the longer term is likely to be a substantial saving in imports.

A significant proportion of direct investment is used in the development of natural resources for export, and minimum export prices may reasonably be established for corporations who export primary produce wholly or mainly for processing by associated companies abroad. A further and increasingly important effect of direct investment on exports is that it may use lower-cost host country manpower to provide components and finished products for other markets.

Although foreign investment is likely to improve the balance of merchandise trade, the servicing costs in terms of the outflow of profits, dividends, interest, royalties and management fees are likely to be substantial over the longer term, and whether foreign investment adds to exchange reserves over the long run is unclear. The transfer of earnings across the border may reasonably be prohibited to the extent that these result from host country tax concessions. This is desirable both to avoid sudden and severe movements across the exchanges which could impose crisis pressures on the exchange rate and to foster stable development.

The most immediate effect of an inflow of foreign capital on the internal economy is that it adds to the supply of domestic savings, resulting in a downward pressure on interest rates and generally increasing fixed capital formation. However, an inflow of foreign capital may deflect domestic savings to employment in fields offering lower returns, and these savings may, indeed, be diverted abroad or even become sterile.

Voting foreign portfolio investment would be preferable to direct investment if substitution did not tend to reduce the transfer of technological and organisational resources to the host economy and to restrict the willingness of the foreign investor to tolerate competition with his home plant. The difficulty of assessing this situation suggests caution in favouring portfolio investment rather than

Table 1: Rates of Return on US Direct Investment [1]

	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971 [2]
Developing countries	18.2	18.3	18.8	19.0	18.7	18.5	20.6	18.8	17.9	19.6
Developed countries	9.5	10.2	10.3	10.1	9.3	8.5	9.0	9.7	10.0	10.3

[1] Percentage return of profits and interest, net of foreign tax, applied to book values at beginning of year. [2] Preliminary.
Source: US Department of Commerce, Survey of Current Business.

Table 2: Net Flow of Private Investment to Developing Countries [1]

(Millions of dollars)

	1961	1962	1963	1964	1965	1966	1967	1968	1969
Direct	1,712	1,408	1,539	1,628	2,326	2,059	1,931	2,428	2,159
Portfolio	593	218	280	398	675	435	775	880	1,260
Total	2,305	1,626	1,819	2,026	3,001	2,494	2,706	3,308	3,419

[1] Including reinvested earnings, sometimes on the basis of estimates.
Source: United Nations, World Economic Survey 1969-1970, New York, 1971.

direct investment (and joint ventures rather than sole control).

Non-voting foreign portfolio investment is generally even less desirable since it is still less likely to be accompanied by an inflow of technology or management skills or by improved marketing arrangements. Moreover, such investment reduces the rates of return for local shareholders. Consequently, non-voting foreign portfolio investment may reasonably be excluded from new issues on the local market, though permitted for non-market issues where there are likely to be special considerations such as high risk.

Increase of Labour Incomes

Probably the most important consideration regarding foreign direct investment is that it is likely to increase labour incomes by providing employment for the unemployed and by upgrading skills through the introduction of more advanced technology. In creating employment, social cohesion is enhanced. This is a major consideration at a time when the labour force is expanding rapidly and outpacing employment opportunities, since democratic governments cannot long survive mass unemployment.

The impact on the profits of locally-owned enterprises is likely to be diffuse. It is likely to be positive in so far as the foreign investment expands demand for the products and services of locally-owned companies, either as direct suppliers or through the effect of increased labour incomes. It is also likely to be positive through the demonstration effect of superior technology and organisation. Negatively, foreign investment in likely to pre-empt future opportunities for profitable investment by local enterprises.

New foreign-controlled ventures may reasonably be excluded if it appears that foreign control of these activities would seriously impede government monetary management of the economy, or result in enclave development with a diversion of financial resources from domestic development to use abroad, or if they appear to pre-empt the favourable opportunity for development under local control within a reasonable period. The industries most commonly reserved for domestic investment in developed countries as a result of these considerations are financial services, resource industries (including agriculture, forestry, fishing, mining and hydro-electricity) and the speculative acquisition of land.

Investment Regulations

New foreign-controlled ventures may also be reasonably excluded where they would result in excessive competition, while excessive concentration in terms of the country of origin requires that positive steps should be taken to promote inward investment from other countries in those cases where domestic entrepreneurs are unable to fill the gap.

Take-overs of local companies by foreign corporations may have favourable consequences for the host economy in particular cases, but the presumption that they generally add less than new investment or reinvestment is sufficiently grounded to warrant a screening process.

Beyond measures restricting take-overs and access to certain industries and developing local management, action to ensure control by local owners is unnecessary and undesirable and tax treatment which discriminates in favour of local control should be reviewed if regulatory measures are adopted since it may then prove to result in an unnecessary loss of revenue. It is legitimate and desirable, however, to discriminate in favour of local control when making grants and loans from public revenues.

In the absence of guarantees to the contrary, it is legitimate for government to change the investment situations of established enterprises adversely and to expect them to comply with new regulations within the same period as new enterprises. Documentation of these regulations and of government attitudes towards foreign investment is of considerable convenience to potential investors but tends towards excessive rigidity. A degree of flexibility is desirable since different investment projects embrace differing potential trade-offs. It is seldom that all policy objectives can be achieved.