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Role of foreign investment in development of a nation

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Abstract
There lived a monkey in an island. Once, there were rains and floods. Water accumulated everywhere and so, the monkey had to climb up the tree as otherwise he would have drowned. As he was up on the tree, he noticed an animal in the waters. Concerned about him, monkey risked his life to take it out of water to prevent the animal from drowning. While the monkey was holding the animal, he saw the animal flopping in his hand in the beginning. Monkey thought that the animal is flopping in happiness because he was just saved from drowning. After a while, the animal stopped moving and the monkey thought that the animal went to sleep. The animal was a FISH and it had just died prematurely.
When discussing the importance of foreign investment on development of a country, this story comes to my mind. There have been a large number of instances of furtherance of foreign investment where foreign investment has helped in development of countries, such as many European countries. However, equal number of instances exists where the furtherance of foreign investment has resulted in death of the country's economy and investment has failed to serve its purpose, such as in many African countries. The issue is that the foreign investment might be a good endeavour but can prove to be futile in absence of understanding of the country's people, the country's past and the country's economy.

Keywords: foreign, development, monkey, island, animal

1. Introduction

Foreign Investments are becoming increasingly extensive in international relations. This paper attempts to show that though the foreign investment targets development of recipient countries, they are motivated by interests of donor countries. Undoubtedly, the foreign investment enables the recipient countries instil economic stability and register economic development. However, this reliance of developing countries on foreign investment causes these countries to be trapped in an economic rat race [1].
FDI has been attributed to having both positive and negative impacts to the developing nations. The nature and level of impacts from FDI depend on the policies of the country receiving the inflows together with its economic state and the available resources [2]. Among the positive effects created by FDI include capital formation, human development, spillovers in the technology and trade integration with the neighbouring nations [3]. A combination of all these positive impacts leads to an economy realizing higher economic growth which in turn helps in alleviating the levels of poverty among the citizens of the host nation.
On the other hand, the inflows can be said to have contributed towards poverty alleviation. Also, FDI inflows continue to be concentrated within a few sectors in the country. The government ought to engage foreign investors so that they can venture into most of the sectors which will see a uniform or near uniform developments in major sectors of the country's economy.
The purpose of the paper is to discuss the merits and demerits of foreign investment for recipient as well as donor countries. The paper will also examine the potential consequences of financial investment on recipient countries, such as shift in power-balance and reduction of self-help efforts. The paper will also examine how such undesirable consequences of foreign investment can be avoided.

2. Fdi in General

The concept of foreign direct investment can be traced back to 1870s. During this period most scholars undermined the impact of FDI and Multi-National Enterprises (MNEs) were perceived to only being interested in making better use of the comparative advantages that existed in the host nations [4]. After the World War 1, the surplus in Western Europe was transferred to the developing countries at that time as FDI inflows. The United States became one of the beneficiaries to these inflows as most of its canals and railroads were partly financed from the inflows received [5]. Firms in developed nations became conscious of the agricultural output and raw material that existed in the third world economies. To acquire these materials, the MNEs had to find a

[1] Krammer, S.M.S. "International R&D spillovers in emerging markets: The impact of trade and foreign direct investment", Journal of International Trade and Economic Development, 19, 2010, p. 591- 623.
[2] *Id.*
[3] Magombeyi, M.T., & Odhiambo, N.M. "Foreign Direct Investment and Poverty Reduction", Comparative Economic Research, 20, 2017, p. 73-89.
[4] Trakman, L. & Ranieri, N. "Foreign Direct Investment: A Historical Perspective", 2016.
[5] *Id.*

way of operating locally in the third world countries; thus, leading to promotion of FDI inflows [6].

There has been an upward trend in the amount of FDI received by the developing nations from the 1980s. Most of these inflows were in exchange for financial assistance and relief of debt by the foreign investors to the developing economies [7].

FDI arises from the globalization of nations. Countries create a way for FDI through integrating their domestic markets to be in line with the global markets. Integration of domestic markets eliminates stringent policies that would have hindered goods and services to move at ease along the borders. Foreign investors get attracted to investing in nations that they consider to have trade alignment similar to their domestic countries [8]. In the past, technological advancements can be attributed to having led to improved means of transport and communication. The improved means of transport and communication did work to the advantage of the investors with ambitions of venturing outside their domestic countries especially during the post-colonial period.

The term FDI can be defined as a phenomenon which involves investment across the borders where an individual residing in one economy obtains an interest in another nation. The individual, group or entity acquiring a stake in another economy is said to be the direct investor or the foreign investor while the interest acquired in the foreign land is referred to as the direct investment enterprise. UNCTAD points out that the purpose of the direct investor is acquiring an effective voice in the running of the direct investment enterprise [9].

Most scholars have identified FDI as the lasting interest from the enterprise in terms of the capital that is made available by the direct investor be it directly or indirectly via other enterprises owned by the investor. From this definition, one gets to differentiate the capital flows from entities and enterprises that ought to be classified as foreign direct investment.

3. Motivations of Fdi

Foreign companies such as MNEs are guided by various motives towards establishing direct investment enterprises. Before a firm invest abroad, it has to first analyze the viability of its operations in the host nations based on the motives behind the investment [10]. Instead of the foreign firm being driven by one motive, the urge and drive could be from the combination of all these motives [11]. There exist five motives that make firms to invest abroad; namely: raw material seeking, market seeking, knowledge seeking, production seeking and political safety seeking motives [12]. Earlier, Dunning argued that firms were motivated to invest abroad by four motives; which are resource seeking, strategic asset seeking, market seeking and efficiency seeking motives. From the Dunning classification, Franco *et al*. categorized their motives into three; namely: resource seeking, market seeking and non-marketable seeking motives [13].

4. Expectations of Host Countries

Countries receiving the FDI have their own expectations as to what the FDI ought to achieve in the country. The government of the host nation expects FDI to accelerate its economic growth while supporting the sectorial development in the country. There exists a positive correlation between FDI and economic growth [14]. Most host countries base their expectations on realizing economy growth through FDI [15]. Economic growth comes with the creation of job opportunities, transfer of technology, managerial and technical expertise among others. Batten and Vo view transfer of technology and acquisition of managerial and technical know-how by the local citizens as spillover effects of FDI to the host nation [16]. 1 The host government will attract FDI from foreign firms based on the levels of the expectations it perceives that the FDI will achieve both in the short run and the long run.

Also, the government expects its citizens to get access to a wide variety of products that didn't exist in the country before and provide substitutes to the existing products. Adequacy of products in the market leaves the consumer with options to choose what they want as per their tastes and preferences. Again, availability of a wide variety of products leads to improvement in the welfare of the consumers as the firms no longer have to overprice their products.

5. Benefits of Foreign Direct Investment

5.1 GDP GROWTH AND FDI

The role of FDI in the development of a country is becoming important as many nations have realized that FDI may bring positive impacts to the host nation. Policy makers have engaged themselves in providing incentives and creating conducive environments to the foreign investors as a way of attracting them to their nations. FDI has been directed towards modernization of the current industries while also developing new and undeveloped industries. The government has to screen and approve any huge amounts of FDI coming into the country using the current investment laws. However, sometimes these investment laws are applied inconsistently. Over the years, the Government of developing countries has been supporting the growth of public-private investments. As a result of the public-private investments, net exports have gone up in the country, leading to increased levels of government's revenues in form of taxes and levies [17].

Presence of FDI inflows has the potential to lead to the following benefits in an economy:

[6] *Supra Note 2*.
[7] *Supra Note 3.*
[8] Jones, J. & Wren, C. "Foreign Direct Investment and the Regional Economy" London: Taylor and Francis, 2016, pp.7.
[9] UN.org (1995), "World Summit for Social Development 1995 | DSPD", Retrieved on 14 August, 2018, from https://www.un.org/development/desa/dspd/world-summit-for-social-development-1995.html.
[10] *Supra Note 8.*
[11] Mold, A. "Foreign Direct Investment and Poverty Reduction: A Critical Reappraisal of the Arguments", 20, 2004, p. 91-122.
[12] De Schutter, O., Swinnen, J., & Wouters, J. "Foreign Direct Investment and Human Development: The Law and Economics of International Investment Agreements", New York. Routledge, 2013.
[13] Franco, C., Rentocchini, F. & Vittucci Marzetti, G. "Why Do Firms Invest Abroad? An Analysis of the Motives Underlying Foreign Direct Investments", SSRN Electronic Journal, 2008.
[14] *Supra Note 9.*
[15] *Supra Note 1.*
[16] Batten, J. A. & Vo, X. V. "An Analysis of the Relationship between Foreign Direct Investment and Economic Growth", Applied Economics, 41, 2009, p. 1621– 1641.
[17] Arazmuradov, A. "Foreign Aid, Foreign Direct Investment and Domestic Investment Nexus in Landlocked Economies of Central Asia", Economic Research Guardian, 2(1), 2012, p 129–151.

1. **Physical capital:** Countries recieve financial capital from the direct investors. The inflows channelled into the country increase its FDI stock. Increase in the FDI stock leads to capital formation necessary in running some of the investments in the economy [18].
2. **Employment and income:** FDI inflows has created employment opportunities to the citizens of countries both directly and indirectly. Through employment, citizens have been earning income thus increasing their consumption levels which in turn leads to increased production and GDP in the country [19].
3. **Transfer of technology, management techniques, and skills:** Technology has an aspect of being transferable. Foreign investors who are attracted to invest in a country leads to the transfer of technology from their home nations. Some of the multinationals have expatriates in the top level management who brings new and better management skills to the employees. Employees are able to learn from the best; thus, can replicate the learnings in improving their productivity and managing their juniors [20].
4. **Market access:** Through FDI, countries have been able to establish better relations with its partners and neighboring nations. Being on good terms with other nations opens the market to the products produced in the country; thus promoting export trade which in turn leads to weakening of the excess trade deficit [21].
5. **Fiscal revenue:** The Government earns income in form of taxes, tariffs and duties from the foreign investors when they are operating within their jurisdictions. The increased revenue collected by the government is channelled towards the improvement of various sectors in the economy such as the extractive sector [22].

Thus, in theory, FDI is said to create positive impacts towards supporting the economic growth of the host nation. However, there is ambiguity when it comes to the empirical evidence of FDI in promoting economic growth. Using the existing theories, some of the impacts of FDI on the host nations are transfers of technology, acquisition of technical and managerial skills and gains in productivity [23]. Such positive effects contribute to the modernization of the host nations. Developing nations continue to be the favourite destinations of the FDI inflows due to the global changes that have been taking place especially in the late 1990s and early 2000s.

The importance of foreign investment in positively changing the landscape of a country's economy is undeniable. South Korea displays an example of how usage of foreign investment can alleviate a country from poverty to one of leading economy [24]. However, because of demographic and political differences, not all countries follow Korea's model. Reduction in foreign investment by British and other European countries to Rwanda resulted in drop of GDP from 7.8% to 6.3% in 2013 [25]. Rwanda example shows heavy reliance of many countries in foreign investment for economic development and large quantum of influence that host countries enjoy over recipient countries [26].

5.2 Poverty Eradication

The Government of New Brunswick defines the term poverty as not having adequate money to help one acquire their basic needs such as food, shelter, and clothing [27]. However, poverty is much more than just having insufficient funds to meet one's basic needs. According to the UN World Summit for Social Development held in 1995, poverty was described as a situation where an individual is undergoing a deprivation from accessing human needs such as food, health, sanitation, clean drinking water, education and information [28]. World Bank describes extreme poverty levels to be with people living on less than $1.90 a day. Poor people are more vulnerable to diseases, political disability, and sluggish economic growth.

There exist two subcategories of poverty; namely: relative and absolute poverty. Absolute poverty focuses more on the unavailability of adequate money to meet the basic needs. Social and cultural needs of an individual are not recognized when using absolute poverty as a measure of poverty. The inadequacy of absolute poverty led to the development of relative poverty as a measure of poverty. UNESCO points out that relative poverty describes poverty levels of an individual in comparison to the economic status of other society's members [29]. One is said to be poor if their living standards fall below the standards of the other people in the society. In most cases, absolute poverty is high in the developing countries while relative poverty is often used in the developed countries.

To reduce poverty among nations, World Bank proposes three strategies that they have tested and proved to work in different countries. The first strategy involves nations working towards developing a labour-intensive economy which will create employment for many people [30]. Second, World Bank advocates that the nations ought to invest wisely on the human capital. Investing in human capital involves empowering and providing necessary skills to the workforce of a country. Increased productivity is realized when a nation invests in its human capital. Lastly, people especially those who are vulnerable and poor need to be insured against the shocks that may make them end up in deeper levels of poverty. Such shocks include economic crises, pandemics, severe weather and variability in food prices.

Globally, FDI inflows provide the citizens in the host nations with increased levels of disposable income; thus, increasing their consumption and alleviating poverty. According to Ratha, remittances such as FDI inflows are essential in the reduction of

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18 *Id.*
19 *Supra Note 9.*
20 *Supra Note 8.*
21 *Supra Note 11.*
22 *Supra Note 16.*
23 *Supra Note 1.*
24 *Supra Note 12.*
25 *Supra Note 13.*
26 *Supra Note 11.*
27 The Government of New Brunswick (2009), "What is poverty? - Economic and Social Inclusion Corporation", Retrieved on July 24, 2018, from http://www2.gnb.ca/content/gnb/en/departments/esic/overview/content/what_is_poverty.html.
28 Yasar M., & Morrison Paul C.J. "Firm performance and foreign direct investment: Evidence from transition economies", Economics Bulletin, 15 (21), 2007.
29 UNESCO (2018). "Poverty | United Nations Educational, Scientific and Cultural Organization", Retrieved on 12 August, 2018, from http://www.unesco.org/new/en/social-and-humansciences/themes/international-migration/glossary/poverty/.
30 World Bank. (2018), "Overview: Poverty", Retrieved on July 28, 2018, from http://www.worldbank.org/en/topic/poverty/overview#1.

extreme poverty in most developing nations [31]. A study by Adams and Cuechuecha point out that FDI is more felt when it comes to the reduction of the severity and depth of poverty as compared to its role in reducing the scale of poverty [32].

Employment income and remittances such as FDI remains to be the key drivers in the fight against poverty reduction in developing countries as the country largely depends on the remittances for its economic growth. The living standards of citizens slightly improve over the years especially to those who have received employment both directly and indirectly as a result of FDI inflows [33]. Social, political and cultural improvements have been realized in the country as there has been diffusion of culture as the locals have an opportunity to learn and practice what is best from the multinational firms operating in the country.

6. Disadvantages of Foreign Direct Investment

6.1 Dutch Disease

Dutch disease is a phenomenon in economics that is used to describe the negative impacts which result from the appreciation in the value of a country's currency. Mostly, the phenomena occur as a result of discovery in natural resource and an increase in the foreign currency inflows such as FDI [34]. The term came into the limelight in 1977 after being published in The Economist Magazine to explain a crisis that faced the Netherlands after deposits of natural gas had been discovered in 1959 within the North Sea. The discovery made the exports of Netherlands' nonoil commodities to be less competitive globally and unemployment shot from 1.1% to 5.1% followed by a decline in the capital investment [35].

According to Kemegue *et al*., an increase in the inflows to a nation supports the expansion of the foreign currency supply which in return leads to both real and nominal exchange rates appreciating [36]. Also, disposable income increases from increased remittances, making the demand of non-tradable to go up. Increase in demand for non-tradable makes the real exchange rate to appreciate. However, countries with little levels of domestic production are forced to increase their imports and this leads to prices going up [37]. Increased prices on the imports make the real exchange rate to depreciate.

A study by Eromenko indicates that FDI inflows can cause the currency to depreciate rather appreciating [38]. The main reason for this depreciation can be cited to the fact that the country imports high-value goods and services which leads to a negative balance of payments. Increased inflows, provides the citizens with additional disposable income which they can spend on the imports; thus, creating a high demand for imported goods. Increased demand for imported goods makes the prices to go up which in turn leads to weakening of the exchange rate in real terms. Real exchange rate depreciates as a result of remittances received into the country [39].

6.2 Resource Curse

The term resource curse is used to explain a situation where nations that are rich in non-renewable natural resources undergo contraction or stagnation in their economic growth. A country tends to focus all its means of production towards producing the non-renewable natural resource while abandoning investments in other key sectors of the economy. As a result, the growth of a country tends to wholly depend on the prices of the natural resources making the GDP to be volatile due to the fluctuations in the global prices of the natural resource.

Economists such as Adam Smith and David Ricardo argued that countries with an abundance of natural resources could capitalize on extracting them to realize a sustained economic growth [40]. Walter Rostow believed that having natural resources was a blessing and developing countries could use these natural resources to help them transition from the current states of under-development to industrial take-off [41]. However, Auty [42] observed that countries with an abundance of natural resources were growing at a slower rate as compared to those with few natural resources. The most affected countries are from Africa, Middle East, and Latin America. Auty referred to this phenomena as resource curse where there exists a negative association between economic growth and natural resources.

Most nations collected just a small portion of the total revenues as a huge proportion of the profits were repatriated by foreign-based companies that were tasked with extracting the resources. Also, he pointed out that the volatile nature of the prices of the natural prices would greatly affect countries that depended solely on them making them grow at a slower rate. Sachs and Warner (1995) undertook research on cross-sectional data among nations rich in natural resources and they confirmed that there existed a negative relationship between economic growth and natural resource [43].

The resource curse means countries rich in natural resources do not develop in accordance with the classical growth theory as they experience slow rate of economic growth. Logically, abundance of resources is expected to improve the revenue of a country which leads to higher economic growth. However, resource curse commonly known as the paradox of plenty makes countries with higher proportions of natural resources to experience slow rate in economic growth. The resource curse makes governments waste the revenues obtained from the sales of the abundant natural resources [44] The government lacks incentives in developing other sectors as it is assured of receiving surplus funds from the exploitation of the natural resources.

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[31] Ratha, D. "The Impact of Remittances on Economic Growth and Poverty Reduction. Policy Brief", 8, 2013, pp.1-13.

[32] Adams Jr, R.H., & Cuecuecha, A. "The Economic Impact of International Remittances on Poverty and Household Consumption and Investment in Indonesia", 2010.

[33] *Id*.

[34] Konings, J. "The effects of foreign direct investment on domestic firms", Economics of Transition, 9(3), 2013, pp. 619-633.

[35] *Supra Note 31.*

[36] Kemegue, F.M., van Eyden, R. & Owusu-Sekyere, E. "Remittances and the Dutch disease in Sub-Saharan Africa", A Dynamic Panel Approach. 259, 2014.

[37] Barajas, A., Chami, R., Hakura, D. & Montiel, P. "Workers' Remittances and the Equilibrium Real Exchange Rate: Theory and Evidence", International Monetary Fund Working Paper, 2010.

[38] Eromenko, I. "Do Remittances Cause Dutch Disease in Resource Poor Countries of Central Asia?" 2016.

[39] Auty, R.M., "Natural resources, capital accumulation and the resource curse", Ecological economics, 61(4), 2007, pp.627-634.

[40] *Supra Note 36.*

[41] *Supra Note 1.*

[42] *Supra Note 16.*

[43] Sachs, J.D. & Warner, A.M. "Natural resource abundance and economic growth", National Bureau of Economic Research, 1995.

[44] *Supra Note 39.*

The manufacturing sector is significantly affected by the resource curse as the government is no longer interested in supporting industrialization since it is getting enough money from the sale of the natural resource. A well-established manufacturing sector is expected to produce high quality goods for exports and local consumption. Also, the manufacturing industry provides employment which in turn leads to improved standards of living. A decline in the manufacturing sector is characterized by a reduction in the output produced in the expense of expanding the natural resources' mines. A weakened manufacturing sector contributes to the increase of high employability rates [45]. Again, nations' suffering from the resource curse tends to waste a lot of their revenue on corrupt individuals instead of using that revenue in reviving the manufacturing sector [46].

7. Conclusion and Policy Recommendations

7.1 Conclusion

From the study, it is evident that economic theories support that FDI inflows have both positive and negative impacts on the economic growth of the host country. A country is able to import more than it can export due to the presence of capital inflows. The increase in imports enables the country to invest more, accumulating the capital that boosts productivity. Improved productivity leads to a positive economic growth and wages go up; thus, providing the citizens with high disposable income to consume [47]. Employment opportunities are created either directly or indirectly as a result of the capital inflows. Directly is through securing a job in the sectors being supported by the inflows while indirect employment occurs through the provision of goods and services to those who are directly employed [48].

Despite, the host nation benefitting from the inflows, at times the country may suffer from the Dutch disease and resource curse [49]. The negative effects arise when the country concentrates on advancing one sector at the expense of the others. In most cases, the sector given priority is usually the extractive sector for a country rich with natural resources. [50] Wages in the sector prioritized goes up making the workers have a preference towards working in this sector rather than working in the less prioritized. In return, manufacturing sector which serves as the backbone of most economies declines affecting the economic growth of the nation [51].

7.2 Policy Recommendations

To realize much benefits from FDI, all the relevant stakeholders and especially the government should consider the following recommendations. First, the government needs to open up its economy by ensuring most of its parts is easily accessible Investments in infrastructure such as roads and rails will make the areas that are rich in natural resources to be accessed at ease. Accessibility of these areas will attract more foreign investors who would be interested in extracting the natural resources that are in abundance.

Secondly, the government ought to improve its energy sector. Power is necessary for running machinery in most sectors. The frequent power loss makes most investors to shy away from investing as they do not want to incur losses during power outages.

Policies on foreign investment need to be relooked carefully. The national government should work towards attracting foreign investors by revising its tax system to the foreigners and opening up trade with its neighbouring countries. However, as the government focus towards attracting investors and multinationals with sustainable projects, it needs to also analyze the impacts of such policies to the domestic industries. Failure to analyze the impact may lead to the policies negatively affecting the local industries making the economy to lose in the long run.

Sectors such as tourism and agribusiness seem to be promising in some countries. The government needs to market itself globally on its potentials. Investment promotion agencies will need to take a proactive nature towards putting the countries on the map of the world on what the country can offer to the foreigners and its comparative advantage. Improving such sectors would create employment while also increase the remittances necessary for economic growth in the country.

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[45] *Supra Note 4.*
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[48] *Supra Note 13.*
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