UNIT TWO: ECONOMIC THEORIES ON FOREIGN INVESTMENT

– Debate for and Against FDI

- Are FDI and Growth **Friends** or **Foes**?
- What are the **Benefits** and **Risks** of FDI for the Host Countries ?
- **Theoretical and Empirical Perspectives**
- There are **Conflicting** view and theories
- Most theories are used as **justification to defend** the **interest of states** in investment
- There are **4(four)** common theories

1. Classical economic theory

- This theorists argue that FI is **wholly beneficial** to the host economy on

– 1. **Capital** inflow,

– 2. Transfer of **technology**

– 3. Creation of **employment** opportunities.

– 4. Transfer of managerial **skill**

– 5. Build/upgrade **infrastructures**

The **WB** and the **IMF** pushed the Idea **conditioned loans as a precondition**

Q? Is there any **Empirical** support???

Critics

- Lacks strong empirical support
- Inflow of capital **outweighed** by **huge out flow** by way of **repatriation**
- Out dated technologies
- Management skill spillover might be **illusive** as top management potion seldom hold by local personnel
- So some view it as a **risk for local capabilities** and a means for **exploitation** of developing countries' natural resources

2. The Dependency theory

- As per this theory, theory **development is not wealth transfer** to the host state,
- Rather it is the **development of the people** of the state as a whole
- So FDI brings **no devt**, but make host **countries dependent** to the developed countries
- So, developing countries have to **liberate themselves from dependency**
- It views FDI as **a risk for local capabilities** and natural resources **exploitation**
- It is **absolute opposition** to the classical theory as it advocate for **absolute insulation** from FDI

3. The Middle Path

- **Balance** between the classical and dependency theories
- **Free market** and **private** economy was accepted as a means to marshal economic development
- MNC threat to the **sovereignty** of developing state can be **regulated** as the host country regulate the FI and
- If there is any **damage** caused on FI the **host state take the responsibility**.
- So, the middle path theory **propagates that mixing regulation and openness**

The middle path ..cont…

- This theory **argue** that there are **positive effect** of MNC/FDI on:-
  - **Capital** flow
  - Transfer of **technology**
  - Create new **employment**
  - Create new opportunity for **export** income
- There are also **negative effects** that host state should **regulate to curb**:-
  - Defeating the **Tax** law of the host states
  - **Hazardous** and disused **technology** and **others**

4. The Liberal Consensus

- This theory is based on premise that **free market yields maximum productivity**
- **Consensus** emerged to make **balance** the market liberal economy if the markets functioning well , however **if markets fail, State intervention is essential to correct** serious market failure
- Developed sates should also **provide assistance**, such as **technical assistance** with regard to the development of **legal** institutions and **economic assistance**.