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THE MULTINATIONAL CORPORATION IN AFRICA

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Introduction

With the passage of time and the accumulation of experience, governments of many developing countries, including those in Africa, are coming to regard the phenomenon of private foreign investment as one whose contribution to economic development cannot be judged by a simple rule of thumb or by a single criterion. The habit of thinking in terms of costs and benefits is beginning to be applied to foreign private investment — even though no satisfactory formula for quantifying all such costs and benefits is or perhaps ever will be available.1/

Despite this difficulty, it is certainly of interest to examine the presumed impact of an investment on the balance of payments of the host country, on locally organized economic activity (backward and forward linkages), on the supply of indigenous factors of production (including entrepreneurs), on local research and development activities, on employment and the allocation of domestic savings. One hypothesis that seems worth considering is that the balance of the various considerations mentioned will differ according to whether the investment is in the primary, secondary or tertiary sector. Without offering a detailed justification for the statement, it is suggested that much thinking about the impact of direct investments in developing countries reflects presumed conditions in the primary ("export enclave") or tertiary (trade and finance) sector; perhaps this is because developing countries, particularly in Africa, have less experience with foreign investments in manufacturing just because of their limited industrial development.

Just as the impact of a direct investment on the economy of the host country is not a simple one, so also it is oversimple to think of direct investments as being identical in form. In recent years it has been seen that the form of such investments may vary from a wholly-owned affiliate to a joint venture with majority or minority participation of the foreign investor and with or without a management contract or a contract for the

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1/ A note on assessing costs and benefits of direct foreign investments is contained in Annex 1.

licensing of know-how. The distinguishing feature of a direct foreign investment — apart from its being an equity investment — is that it establishes a measure of control over the enterprise in the host country.[1/] By its nature an affiliate of a multinational corporation will almost always represent a direct investment (unless, for instance, it is purely a licensee); and conversely the bulk of direct investment is owned by multinational corporations. The purpose of this paper is to examine some of the characteristics of this way of organizing production from the point of view of African countries.

4. The distinguishing feature of the multinational corporation is that its operations are distributed among two or more countries to a significant extent. There is no consensus on what constitutes a significant extent, but it may be suggested that an enterprise with more than 20 per cent of its assets distributed among two or more countries may be considered a multinational company. Perhaps the more important aspect of the definition is the number of countries in which the corporation has affiliates, but the other condition of a substantial international dispersion of the firm's total assets is also significant. The point is that the more widespread its productive operations and the larger the share of its activities in more than one country the more different its mode of operations and its probable impact on any one country. It goes without saying that most multinational corporations would be classified as large by any standards. Further, their multinationalism, consists in the nature of their production activities, not in the international dispersion of the ownership, which is, as yet, rare.

5. What makes the multinational corporation worthy of special scrutiny? The answer, basically, is two-fold. Because of its size and world-wide operations and outlook, such an enterprise has capabilities which are often significantly different from more narrowly constrained firms. In the field of manufacturing, particularly, it may be a powerful mechanism for organizing production and possibly trade in an efficient way, especially from a global perspective.

1/ The dividing line between direct and so-called portfolio investment is arbitrary. Direct investment is usually taken to include investment representing a share in the equity of an enterprise of 10 per cent or more held by a single foreign firm or a closely knit group of firms. This definition allows for an investment representing a minority equity share to be classified as direct, whereas most of the concern in developing countries (political as well as economic) is with enterprises having 100 per cent or at least a majority of the equity in foreign hands.

On the other hand, the operations of a multinational corporation may conflict with the aims and interests of a particular country in which it operates. In other words, whether global productive efficiency coincides with equity for all the constituent countries is another question. The essence of the problem raised by the multinational corporation is to determine whether a serious conflict exists and to judge whether the advantages of this form of direct investment outweigh the disadvantages to the "host" country.1/

The nature of the multinational corporation

The most extensive development of the multinational corporation has occurred during the past two decades or so through the growth of operations in Europe by affiliates of United States corporations. There is, however, a growing number of European-based firms, including some of long standing, that fit into this category -- for example, Unilever, Shell, Imperial Chemicals, Fiat, Volkswagen, Michelin, Pechiney, CIBA -- and a rapid growth of Japanese multinational firms.

A number of multinational firms controlled by European and North American interests have operations in developing countries. However, with the exception of firms engaged in mineral development, including petroleum, and a few in trade, banking and insurance, these operations are thus far a small part of their total activities. As will be seen below, the marginal character of these operations, particularly in the field of manufacturing, inevitably colours their attitude toward investment in these countries. However, with the increased emphasis on manufacturing in the developing countries, the involvement of multinational firms may well expand more rapidly, as has already occurred in a few cases, for example in China (Taiwan), South Korea, Brazil, and Mexico.

1/ Its operations also may not coincide with the perceived interests of the country in which it is "based", but that is a matter which is outside the scope of this paper. It may be observed, however, that an attempt by the "base country" to exert control over a firm's operations in other countries (for example in pursuance of tax or balance-of-payments policy) may lead to conflict with a host country regardless of the desires of the corporation itself.

A company with a world-wide network of production and/or marketing will tend to adopt a different form of organization and control from one with limited overseas interests. Organizational patterns, the product of historical and personal forces, would not be expected to exhibit complete uniformity, but observers have noticed certain tendencies in these firms. In the early phase the management of overseas operations tends to be concentrated in a separate international division. Then, as overseas activities grow in importance, there is pressure to integrate these operations with the rest of the company's operations by establishing direct links between the main operating divisions of the company, according to both product and function, and its overseas affiliates. In this more advanced form the attention of the chief executives is focused on domestic and overseas operations with little distinction between the two. In other words, the decision-making process is global in scope. This refers to the entire range of major decisions: finance (the raising of capital and the management of foreign exchange), investment, production, personnel assignment and training, research and development and such matters as action in the face of governmental measures, particularly taxation, exchange restrictions and commercial policies.

It is not intended to suggest that the national affiliates have no scope for independent action. In day-to-day operations, in marketing policies, in personnel matters at the plant level, to a limited extent in research and development, and possibly in investment decisions below a certain size a policy of decentralization will normally be followed. But in such basic questions as expansion or contraction of investment, determination to produce or redesign a certain product, production or purchase of equipment and other inputs locally or abroad, exports by affiliates to the world market, and research and development activities the control is generally centralized.

In regard to operations, one important question is how the enterprise gets its information about marketing opportunities and conditions of production. A multinational corporation will tend to have access to a wider range of information than a firm of lesser scope. This access will result partly from an active searching out of investment and marketing opportunities in the major regions of the world. Partly it will ensue from the passive receipt of information through a variety of channels such as banks, government agencies, international organizations, consulting firms and the like.

In making decisions concerning operations in a developing country the multinational corporation is not, in principle, in a different position from indigenous investor. Basic conditions, such as the size of the market, the cost of production, the degree of protection and of actual or threatened competition and the various elements of risk (the investment climate) must be considered. The basic objective is profit maximization, in this case on a global basis 1/. The only difference is that in its search for profits, the multinational firm has greater scope for manoeuvre; for example, it may use one affiliate to produce components for another's assembly operations (as in the case of IBM or Olivetti) or it may close down certain high cost operations and expand elsewhere; or it may use the operations of one affiliate to finance those of another.

This greater manoeuvrability can lead to tension between a multinational corporation and a host country. In the field of mineral production, for instance, the search for low cost sources or sources considered less risky for political or other reasons may result in a different rate of production from that which might be undertaken by a national enterprise. Likewise, in the development of a regional market, among several countries the multinational corporation, unless forced otherwise, will naturally tend to gravitate to the low cost area within the region. If the governments of the region are pursuing a joint policy of planned location of industries it is up to them to adjust their policies to prevent this from happening if it conflicts with their plans. In practice the problem may be less serious than appears at first sight because the big investments in heavy industry which would attract the multinational firm are likely to be located mainly according to criteria of cost, so that the area of conflict in a regional market largely concerns "footloose" industries. In this case, as stated, it is up to the governments concerned to enforce a policy of industrial location that fits their mutual interest.

1/ It has been argued (by Prof. Galbraith, among others, in The Modern Industrial State) that an independent motivating force in business enterprises is maximizing growth or size as such. Whether this is an independent motive or whether growth is taken by the firm as a long-term proxy for profitability is an unresolved question.

In one respect, the multinational firm may view investment decisions differently from a firm with narrower geographic interests. Since its operations in a particular developing country are marginal in most instances to its total operations, it can ignore this country or even developing countries generally with little loss to its total profits. On this reasoning, it might be argued that a stronger force of attraction is needed to induce a multinational firm to make an investment in a particular country.

This situation raises the much-discussed question of the offering of tax and other concessions by the host country and of the advisability of a united front ("harmonization") on such matters by developing countries as a whole or, more realistically, by groups of such countries. The evidence indicates that the size and potential growth of a market and the estimation of risks particularly from exchange restrictions are far more important, particularly to the multinational corporation, than tax and similar concessions.[1/]

On the other hand, because the firm's investment in a developing country places very little of its total assets at risk, it may attach a smaller risk premium to an investment in a developing country than would a firm whose assets are smaller and more concentrated geographically. In some instances multinational firms are able to take a longer view of an investment prospect. They may be willing to commit capital to production for a particular market of relatively limited size on the calculation that in the long run it will be profitable to establish themselves in a potentially expanding market. The multinational firm also possesses certain advantages in being able to spread the overhead costs of investigation of a project's feasibility, of plant design, and of research and development.

The multinational corporation and African development

In order to consider the potential impact of the multinational corporation on African economic development it is necessary to have an idea of the current and prospective nature of private foreign investment opportunities in the region.

1/ See R.S. May, "Direct Overseas Investment in Nigeria, 1953-63", Scottish Journal of Political Economy, Vol. 12 No. 3, 1965.

Foreign investment in Africa appears in all the main branches of the economy — agriculture (plantation type), mineral production, manufacturing and services.[1/] There is great variation from country to country, particularly in the role of foreign investment in agriculture and mineral development. Broadly speaking, the era of foreign investment in agriculture has ended, though the impact of foreign investment in the food processing industries on agricultural production should not be underestimated. The same may hold good for foreign investment in some of the inputs of agriculture, namely fertilizers and agricultural implements, since the search for markets is a powerful motive for firms engaged in these activities to encourage the development of the agricultural sector. The number of foreign investments in manufacturing is greater than in the other sectors, even though in particular countries the total value of investment in the resource-based sectors is larger. Broadly speaking it is the manufacturing sector which is expected by most African countries to show the highest rate of growth, and it is in this sector that most of the issues of policy with respect to private foreign investment will arise and are in greatest need of clarification.

i) <u>Natural resources</u>

So far multinational corporations have been attracted to Africa largely by the prospect of developing natural resources for export. The exploitation of petroleum, iron ore, copper and bauxite are leading examples. A few investments in the agriculture sector remain, particularly in the development of palm products in West Africa, and there have been some recent investments in tea, sugar production and meat packing in East Africa.

In the development of natural resources, the multinational corporation is geared either to selling the product on the world market directly or to using the raw material as an input for its own internationally integrated processing operations, as in the case of palm products, copper and bauxite. The main conflict that arises is over the degree of local processing. Three forces operate here. One is the existence of processing facilities controlled by the parent firm in the industrialized countries. The sunk costs in such

1/ To avoid confusion, it should be stated that the discussion in this paper excludes consideration of investments by non-African residents.

facilities may lead the enterprise to limit the degree of processing and hence of value-added in the exporting country. A related factor is the establishment of marketing links in the industrialized country which the parent firm finds convenient to utilize. It should not be overlooked that the failure of multinational firms to establish processing of facilities for mineral exports in developing countries may reflect a fear of nationalization or other risks; thus a vicious circle may be created, since the failure to establish such facilities may increase pressure to nationalize.

A second factor is the commercial policy of certain industrialized countries. This frequently provides for higher rates of effective import duty on processed than on unprocessed raw materials and thus tends to perpetuate the situation in which there is a vested interest in maintaining processing facilities in the industrialized countries.

A third factor is probably inertia on the part of the firms in the development of technology which will facilitate a higher degree of processing of agricultural products in tropical countries. This can be and has been remedied in some cases by appropriate research and development in the exporting countries.

In the past, limitations on the processing of natural resources for export by multinational corporations have perhaps also been an outgrowth of their concern over the efficiency of local processing operations in Africa. The situation in this respect is rapidly changing and is certainly capable of further change. Examples of recent successful increases in the degree of local processing are found in copper (Zambia), iron ore (Liberia and Mauritania), cocoa (Nigeria, Ghana) and sisal (Tanzania).

These developments have come about partly by pressure exerted by African governments on multinational corporations. Probably they also reflect an increased local capability to carry out efficient processing operations. Finally, as in the case of sisal, they may reflect an improvement in the marketing capability of African-based enterprises, that is, their ability to keep in touch with world markets and to adjust production operations to shifting demand conditions.

(ii) Services and trade

Foreign investment in the provision of services is found mainly in wholesale and retail trade, commercial banking and insurance and in the hotel and tourist industry.

The classical pattern of foreign investment in trade (exemplified until recently by the United Africa Company in West Africa), in which the foreign enterprise is involved in both exporting primary products and importing consumers' goods is rapidly disappearing. On the export side this is the consequence of the emergence of national marketing boards which perform a variety of functions of which export is one. The marketing boards may use foreign firms as their agents in overseas shipments, but this is on a contractual basis, with margins carefully scrutinized. The increased volume and variety of imports has also modified the former position in which a single firm (frequently the same one as dealt in exports) was the main channel for imports. The distribution and servicing of durable consumers' goods and petroleum products is often carried out by agencies of large international firms, frequently in partnership with a local firm.1/ For some types of consumers' goods such as radios, television sets and refrigerators a substantial part of the distribution and servicing is done by large multi-national trading firms (such as the United Africa Company, Mitchell Cotts, Besse & Co.) which are franchised distributors of particular products.

It is probably not far from the mark to say that much of the thinking and writing about private foreign investment in Africa has been based on experience with the "enclaves" producing primary commodities for the world market and with the "tertiary" sector, namely wholesale trade, banking and insurance. This point is mentioned because it seems important to determine whether the considerations applying to the primary and tertiary sectors, if valid, apply also to foreign investment in manufacturing for the home market (including regional or sub-regional markets) which is bound to be, for the foreseeable future, the major form of manufacturing in most African countries and an increasing field for multinational firms.

1/ Another arrangement which is important is some countries is the so-called exclusive agency agreement under which the overseas manufacturer pays a fixed commission and guarantees the local distributor the exclusive agency. The agent stocks the goods at his own expense and distributes them. He undertakes not to handle similar lines. A sample of such an agreement is reproduced in M.J.H. Yaffey, Balance of Payments Problems of a Developing Country: Tanzania, Weltform Verlag, Munich, 1970.

Three inter-related concerns are frequently expressed with respect to direct foreign investments in Africa, particularly investments in the tertiary sector. The first is that the foreign firm, as a result of a monopolistic or monoposonistic position, will earn abnormally high profits which, furthermore, will not be captured by the local tax system.1/ The most frequently cited measure of evasion is the over-invoicing of imports on the part of trading (and possibly manufacturing) firms and the under-invoicing of exports on the part of firms acting as brokers in the marketing of primary commodities. It may be observed, however, that if the tax system of the company's home country is reasonably efficient (excluding the case in which profits are routed to a tax-free haven in a third country or to finance operations outside the home country) there seems to be no strong motive for over-invoicing imports except as a means of evading either existing or anticipated foreign exchange restrictions in the host country.

A second concern is the impact of profit remittances on the host country's balance of payments.2/ Assuming the foreign exchange "gap" is more of a constraint than the savings "gap", outward transfers by foreign trading firms, whether regarded as normal or monopolistic, will naturally be a source of concern to the authorities. In a broad sense, the issue is one of import substitution: that is, whether the host country can replace the services rendered by the trading firms with enough efficiency to dispense with the

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1/ Referring to foreign investment in Nigeria, a student of the Nigerian economy states, "The quality of administrative supervision could not forestall or prevent dishonest business accounting for tax and other official purposes". See "The Economy of Nigeria", by O. Aboyade in <u>The Economies of Africa</u>, P. Robson and D.A. Lury editors, London, 1969 p.178.

2/ On measuring this impact see Annex 1.

services of such firms.[1] It may be added, that, given a regime of exchange control, private firms owned by residents would probably also be motivated to transfer capital abroad by over-invoicing imports and by any other practicable means. So the choice, in fact, may be regarded as one between private operation of international trading and state trading enterprises.

A third point that has been made about foreign investment in the services sector, particularly in commercial banking and insurance, is that it restricts effective control of the economy by the authorities of the host country.[2] In the case of commercial banking the main issue is presumably the granting of loans to resident firms. If administrative arrangements are effective, the channelling of credit to preferred branches of industry can be fostered by restricting credit to disapproved activities; likewise investments by

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1/ This consideration appears to have been important in the case of recent action in Tanzania. Commenting on the nationalization of firms in trade and finance, one observer states: "It is import substitution in services, and in some cases the cutting out of unnecessary services, or reduction of their costs, that constitutes and profits; reduction of debits for insurance; reduction or cutting out of confirmation or buying commissions on imports; extension of national shipping and aircraft services". See M.J.H. Yaffey, Balance of Payments Problems of a Developing Country: Tanzania, Weltforum Verlag, Munich, 1970, page 195. According to this author on any given merchandise import into Tanzania, thexe changes are likely to reduce foreign exchange costs by between 5% and 16%. The author states that it is not yet possible to calculate an average figure for the whole of Tanzania's trade but he suggests a figure of "upwards of 5% on all imports and possibly 3% or 4% on all exports".

2/ Thus, the Government of Tanzania, in describing its policies with respect to expansion of public ownership in the financial and industrial sectors refers to the ability to "pursue a more effective industrial strategy than that possible under private enterprise". See Tanzania Second Five Year Plan for Economic Development, 1 July, 1969 - 30 June 1974, Vol. I, p. 75, Government Printer, Dar-es-Salaam, 1969. Reference is made also to two other considerations: (i) the possibility of creating "a genuine Tanzanian industrial know-how faster than under conditions of unrestricted private investment" and (ii) the local reinvestment of profits made in nationalized industries, which is expected to help the balance of payments, other things being equal.

insurance companies can be regulated to conform to official investment policies, provided their are adequate outlets. The problem for governments is to strike a balance between the advantages offered by the international connexions of commercial banks and insurance companies and the various objectives of national planning already referred to, including balance-of-payments considerations.

One tendency observed in developing countries in Latin America and Asia and, to a limited extent in Africa, is for large international trading firms to branch into the manufacturing of import substitutes in response to import restrictions due either to balance of payments difficulties or to a deliberate policy of import substitution.

Thus, the United Africa Company, which was predominantly a trading company, invested some £15 million in Nigerian industrial projects between 1956 and 1961, such projects rising from 15 per cent to 47 per cent of the company's annual capital expenditure.[1] At the same time the company was withdrawing from traditional retail trade and concentrating on wholesale trade and modern retail trade, particularly supermarkets. The company established a special department which examined over 300 projects for industrial investment, of which about one-third were developed. In order to acquire the technical know-how, the company associated itself with firms already producing the product, in most cases British firms.

One slightly different and potentially interesting development in this direction is the recent international activities of certain Japanese trading companies. These are sometimes referred to as the "Big Ten", of which Mitsubishi, Mitsui and Sumitomo, which are backed by their respective industrial empires, are considered to be the most powerful.[2] In Japan these firms are

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1/ See United Africa Company, <u>Statistical and Economic Review</u>, Nos. 22,23, 26, 28.

2/ The others are Marubeni-Iida, C. Itoh, Nissho-Iwai, Toyo Menka, Michimen, Kanematsu-Gosho, and Ataka. The information which this paragraph is based is from an unpublished study prepared for UNITAR (United Nations Institute for Training and Research) on the transfer of technology to developing countries by private enterprise.

referred to as "general traders" or "mother hen" corporations. They have world-wide sales and purchasing networks. About 80 per cent of Japan's contracts for technology exports are reported to have been negotiated by these trading firms. They earn not only brokerage commissions from trade in commodities but also an increasing amount of dividends from their overseas ventures. These firms are engaged not only in direct exports and imports from and to Japan but increasingly they have acted as agents in the foreign trade of other countries, e.g. South Korea, with countries other than Japan.

Due to their far-flung sales and purchase networks the trading firms are usually among the first to learn of any demand for Japanese technology in foreign countries. At the same time they are constantly securing information on the potential supply of technology from their closely linked manufacturing affiliates in Japan. This linkage is indicated by the following overseas ventures as of March, 1970: Mitsui, 96; Mitsubishi, 531 C. Itoh, 45; Kanematsu-Gosho, 28; Misso-Iwai, 20; Toyo Menka, 18; Sumitomo, 15; Nichimen, 15; Ataka, 6.1/ Among the countries in which these trading companies are involved in manufacturing ventures are: Taiwan, 36; Thailand, 31; Brazil, 22; Malaysia 20; Singapore, 19; Hong Kong, 16.2/

In many cases the Japanese involvement was in response to import restrictions affecting Japanese products. This is illustrated by the establishment of galvanizing plants through the auspices of Japanese trading firms in Nigeria, Sudan, Morocco, Ethiopia, Ceylon, Indonesia, Singapore, Guatemala, Peru, Venezuela and the Dominican Republic. Investments in the textile industry also resulted from the same situation.

The Japanese trading firms are linked not only with large Japanese manufacturing firms but are reported to be increasingly called upon by small and medium-sized Japanese enterprises which are interested in overseas ventures but lack adequate means. What is involved is the multinational trading company as a pathfinder and entrepreneur. It is not suggested that this function has been or could be effectively performed to a significant extent by the traditional trading companies from Western Europe with which African countries are principally familiar. But it would be well for African countries to bear this possibility in mind.

1/ Source: Ohru Bizinisu (All Business), Tokyo, June 1970.

2/ Ibid., page 56.

In the development of hotels, which are a major element in the tourist industry, a special type of multinational enterprise is found in the form of franchised hotels which form part of a world-wide chain (e.g., Hilton Intercontinental). In most cases the capital for such hotels is local, frequently a mixture of public and private funds. The international franchiser provides the design, training of staff, management and to some extent the service of linking the hotel with tourist agencies throughout the world.

In this field, the substantial success largely reflects the ability of the multinational firm to spread overhead costs in planning and designing. The facility as well as increased efficiency in procurements and in operating and marketing.

(iii)Manufacturing for the domestic market

While the bulk of African manufacturing thus far involves the production of light consumers' goods for the domestic market (apart from the processing of primary products for export) there is considerable variation among countries in the composition of manufactured output and in the value added by local manufacture. For present purposes the question is to what extent do multinational corporations participate in the manufacturing sector and what are the prospects for their further participation?

A few examples of such activity can be cited. Philips N.V. of the Netherlands, a major producer of electrical appliances, has established several plants in Africa producing small radios for the domestic market using components imported from the parent company. Bata Ltd., which may have production and distribution facilities in more developing countries than any other multinational corporation, has plants in a number of African countries. In addition to technical guidance from the parent firm, the procurement of raw materials by this firm is organized on an international basis to take advantage both of local capabilities and of the advantage of large-scale purchase on the world market. Another industry in which world-wide enterprises are involved and which is growing in Africa is the production of automobile tyres.

At the present stage of development of African manufacturing, however, the large multinational company is the exception rather than the rule. The immediate explanation of this is simply the fact, already mentioned, that at the present stage of industrial development in Africa production consists mainly of light consumers' goods demanding relatively simple and easily accessible technology. As the composition of manufactured output shifts to more sophisticated intermediate and final products, hopefully stimulated by the enlargement of markets through sub-regional co-operation, the question of participation in this process by multinational corporations in such fields as automotive equipment, electronics, chemicals, pharmaceuticals, pulp and paper and the like will inevitably arise. But for the present, manufacturing plants are preponderantly set up by foreign interests of limited size and geographic spread or by state enterprises with a foreign firm supplying equipment and/or managerial assistance, with perhaps a limited foreign participation in the equity.

From the point of view of productive efficiency and affiliate of a multinational corporation has certain advantages. Its output will probably enjoy a higher degree of standardization and quality control than would otherwise be the case. It can draw on the know-how of the parent firm and its experience in the training of personnel both locally and, for higher ranks of personnel, at the firm's plants in industrialized countries. Its imported components may be obtained in some cases from the parent firm at prices below those at which they can be bought on the open world markets. The parent firm can afford to support more substantial research and development operations than an independent local firm or a small foreign firm. The local affiliate can benefit from the managerial and technological experience of the firm in operations in other developing countries.

On the other hand, there are several possible points of conflict between the multinational firm and the host country. One is over the degree of local content, especially if the parent firm itself has facilities outside the country for producing components. In the final analysis, the host country, through its regulation of imports, can determine how far it wishes to go in the encouragement of local production of import-substituting components. Every developing country must seek a point of balance between cost-raising import substitution of components and providing a stimulus to potentially efficient local production that goes beyond "finishing touches." So far as forward linkages are concerned, experience indicates that the affiliates of multinational corporations are usually aggressive in promoting local sales of their product; perhaps the most important example of this for African countries in the near future will be in the field of agricultural implements, fertilizers and other agricultural inputs.

For broad developmental objectives, the linkage effects which are most significant are those which not only increase local value-added by also upgrade local factors of production, particularly entrepreneurs and the labour force generally. Thus far in Africa, the instances of the latter, apart from in-plant training of labour, are largely confined to retail trade (notably in the distribution of petroleum products and, as other interesting examples, the retail network of the Bata shoe company and the withdrawal from retail trade of the United Africa Company). The ability to secure advantages from backward linkages as the manufacturing sector expands will depend heavily on the pursuit of national policies affecting the efficiency of medium-scale industries.[1/]

In the production of consumers' goods, particularly, the "finishing touches" issue is bound up with two others. One is that the foreign firms involved are usually former exporters to the country, with a disposition to continue to export as large a portion of the input as possible. Apart from the economics of import-substitution, the issue is largely one of bargaining; in a number of instances the bargaining position of the host country depends on competition among multinational firms, which appears to be intensifying, particularly since the limited size of the market may tolerate only a single firm for a considerable time.

A logically quite separate issue which seems, nevertheless, to become intermixed with the critique of "finishing touches" is that import-substitution by multinational firms involves the production of consumers' goods that are the same as those consumed in affluent industrial societies. This is obviously more a critique of income distribution in the host country than of the operation of the multinational corporation. The question of product design and research and development policies is discussed further below.

In view of the several positive features which a multinational corporation may contribute to the efficiency of production in a developing country it is important to consider whether there are significant drawbacks to the economy

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1/ See E.C. Edozien, "Linkages, Direct Foreign Investment and Nigeria's Economic Development," The Nigerian Journal of Economic and Social Studies, July, 1968.

of the host country. Some aspects of this question are considered below, particularly in connexion with the choice of technology and the impact on local factors of production. Here it seems appropriate to mention the question of over- and under-invoicing, already discussed in the context of trading firms.

Since the multinational firm in manufacturing will be producing mainly for the domestic market (including the regional African market where one exists), the question of under-invoicing of exports does not arise. As regards over-invoicing of imports it is hard to generalize; the higher the domestic content, the less important the issue.

Two points seem worth making. One is whether the enforcement of an "arms-length" pricing rule in regard to imports is administratively feasible. The other is whether the large multinational corporation because of its impersonal and bureaucratic procedures will usually follow routine pricing procedures rather than seek to make what, to it, are relatively minor adjustments in order to escape exchange restrictions in the host country.

It is interesting that the United States Government has apparently been concerned with the opposite phenomenon, namely the under-invoicing of United States exports of goods and of services (such as parent firm's expenditure on research and development) by United States firms in transactions with their affiliates overseas, which constitutes an evasion of the United States internal revenue code (Article 482). The rationale for the alleged action by United States firms is presumably to escape the comparatively high level of United States corporate income tax and thus accumulate funds for possible future capital or other expenditure outside the United States. From the point of view of developing countries an interesting aspect of the United States policy is the insistence by the United States authorities that centralized research and development expenditures should be appropriately allocated to the various affiliates of a multinational corporation. In one instance the government of a developing country has protested the inclusion of such costs in the accounts of a United States affiliate in its country on the grounds that the research and development expenditure in question had no relevance to the operations of the affiliate.

(iv) Manufacturing for export

It has already been mentioned that multinational corporations in Africa are thus far mainly engaged in the production of primary commodities for export. In some cases these firms have seen fit or have been induced to increase the degree of processing before export. Thus far this is the main form of manufacturing for export from Africa. In several countries food processing for export has developed (canned fruit, canned meat and meat extracts). Despite the relatively low wage rates it is premature to expect the development of export-oriented manufacturing industries of the type recently expanding in Asia, based mainly on low wage rates and a highly disciplined labour force. Part of this development has been the result of a policy of multinational firms to "source" components in low cost countries. An outstanding example is the production of labour-intensive electronic components in China (Taiwan). While it is too early to expect this development in Africa (except within the framework of sub-regional co-operation), long-range planning for industrial development should take this possibility into account.

Between 1960 and 1968 the export of manufactures from developing countries grew by about 13 per cent per year.1/ However, this remarkable expansion is largely accounted for by a small number of countries, of which the only significant participants in Africa were Tunisia and Nigeria. While the number of products involved is large and growing, the bulk of the exports consists of processed foodstuffs, clothing, textiles and leather goods. An interesting feature of the expansion is that it includes a number of products produced exclusively or predominantly for export. Many of these products, for technical reasons, are produced under the auspices of multinational corporations. In these cases the importance of the technological, managerial and marketing links is obvious.2/

1/ This refers to SITC groups 5 - 8, ecluding non-ferrous metals. See GATT, International Trade, 1968, pages 233 - 235.

2/ It is estimated that between 1957 and 1966 Latin American exports of manufactures rose from $709 million to $1,613 million and that subsidiaries of United States firms accounted for 65 per cent of the increase of $804 million. See The Effects of United States and Other Foreign Investment in Latin America, The Council for Latin America, Inc., New York, 1970, p.29.

The exports of manufactures by developing countries fall into two groups: one, finished consumers' goods and some intermediate products sold in world markets and two, parts and components for incorporation into complex equipment or durable consumers' goods produced in industrial countries. Multinational firms are involved in both categories, but more significantly in the latter. This second case still leaves room for a variety of international business arrangements. One, developed notably in Yugoslavia, is the "co-operation agreement" involving receipt of production, training and marketing assistance from a foreign firm against payment in the form of parts and components with no equity participation.

The multinational corporation and the choice of technology

The multinational corporation faces a different set of factor prices than an indigenous firm in a developing country. Thus, its choice of technology may be expected to reflect its ability to draw upon the world capital market (where interest rates are generally lower and, in any case, the social cost of capital is lower than in the developing countries), which will lead it to reproduce the technological choices made in the industrialized countries.

The question is whether, as some observers have alleged, this situation introduces a significant bias toward capital intensity in the technology transferred to affiliates of multinational corporations in developing countries.

A preliminary point well worth making is that the scope for efficient substitution of labour for capital in manufacturing processes depends on the particular product. In continuous process industries (chemicals, pharmaceuticals, metal refining, oil refining) and in the production of many consumers' goods and intermediate goods on an assembly line the scope for such substitution is quite limited, except in certain ancillary operations, particularly materials handling and packaging. The main types of activity in which a gain (measured in terms of social costs) may be achieved by the substitution of labour for capital are in road-building, irrigation, housing and construction generally and in the production of woven fabrics, clothing, woodworking, leather, some foodstuffs (including foodstuffs for local consumption in rural areas), bricks, tiles, and some of the simpler metal products.[1] A clear distinction should be made between altering factor proportions in a particular industry and selecting for development industries or products which are relatively labour-intensive.

A more subtle point is the question why the host country should be concerned if foreign capital, which presumably would otherwise not be available, is embodied in more capital-intensive processes than would be optimum for the utilization of local capital, given socially optimum factor prices based on the indigenous supply of capital and labour. One answer may be that the demonstration effect of such technology is bad for indigenous firms. A second point is that the use of capital-intensive technology by manufacturing firms, whether foreign or local, makes less of a contribution to the absorption of labour. However, as is now widely agreed, the expansion of the modern manufacturing sector offers, in the medium-run, no real direct solution to the problem of absorbing the massive numbers of school leavers now facing many African countries. Another consideration is that when the financing of an enterprise is mixed, as it is increasingly in African countries, the foreign partner's views on technology may prove dominant, in which case there may be a bias towards capital intensity. The same applies when expansion of the investment occurs from reinvested earnings, which represents in effect a use of domestic capital; and the utilization of depreciation allowances to finance the reproduction of the original capital-intensive choice represents an allocation of resources that it would be desirable to employ in a less capital-intensive manner.

Even if the degree of flexibility in the production function is frequently less than commonly assumed, there is no reason why the government of the host country should not pursue policies which would tend to encourage firms to choose optimum factor proportions. One policy which tends to have the opposite effect is that of permitting accelerated depreciation as an investment incentive. Another, which affects indigenous firms more than foreign enterprises, is the maintenance of an overvalued exchange rate, which makes imported capital equipment appear unduly cheap.

1/ See A.F. Ewing, Industry in Africa, London, 1968, pp. 12 - 13.

In weighing the evidence on technological choice and adaptation by multinational firms, it is important to distinguish between a comparison of foreign and domestic firms and a comparison between foreign firms and some abstract target of higher labour intensity. Such limited evidence as is available indicates that foreign-controlled firms have adopted no more capital-intensive methods than comparable local firms and have introduced modifications in production processes to take advantage of low labour costs in many instances. In a sample of Mexican manufacturing firms it was found that the foreign firms tended to adjust more to local factor prices more than indigenous enterprises in the same industry, perhaps because of superior managerial capability.1/

In a comparison of technological choice by matched pairs of subsidiaries of United States firms and of local firms in the Philippines and Mexico it was found that the United States firms did use more capital per worker than their local counterparts, but this was due to heavier investment in buildings and inventories. They did not appear to use more equipment per worker than their local counterparts.2/ In only one of sixteen plants studied did it appear that automatic or other equipment was engaged in trivial activities which could have been done equally well by unskilled labour. In a few cases the existence of high capital intensity was found to be due to the installation of excess capacity by firms which were in effect granted a near monopoly and corresponding protection against imports.

Similar findings were made in connexion with a recent study for UNCTAD on the balance-of-payments effects of private foreign investments.3/ The investigators did not investigate in depth the scope for profitable substitution of labour for capital (and of local materials for imports) but

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1/ See W. Paul Strassman, Technological Change and Economic Development, Cornell University Press, 1966.

2/ This information comes from an as yet unpublished study by UNITAR (United Nations Institute for Training and Research).

3/ See "Balance-of-payments effects of private foreign investment: Case studies of Jamaica and Kenya," UNCTAD document TD/B/C.3/79/Add.2, 21 May, 1970.

their impression, based on a sample of firms in Kenya and Jamaica, was that the scope for such substitution was small, at least in the short run. In their analysis, therefore, it was assumed that a local producer replacing a foreign firm would use much the same technique of production as the foreign firm.

What this fragmentary evidence indicates is that the technological choices of foreign and local firms in fairly sophisticated manufacturing enterprises are similar. It does not, of course, demonstrate conclusively that if different signals were given to firms by the price system in the host country (with reference to the social cost of labour, overvalued exchange rates, or interest rate subsidies) there would not be further scope for factor substitution in conformity with factor proportions. However, it seems as if scope for greater labour-intensity depends more on the availability of co-operant factors or on modifications in the economic and social framework. Perhaps the most substantial step that could be taken in the modern manufacturing sector toward higher labour-intensity is to organize the working of two or three shifts; this requires more supervisory labour (human capital) and modified social arrangements. Thus, in Japan the achievement of higher labour-intensity in several branches of manufacturing is attributable mainly to the use of labour-intensive methods by sub-contractors which, in turn, is possible because of their managerial efficiency.

Perhaps of equal if not greater importance in the African context is the modification of technological processes to adjust the scale of plant to the limited size of the market and the undertaking of research and development to utilize unconventional indigenous raw materials. In both respects a certain amount of progress has been made by multinational firms, though no doubt more could be done. An interesting example of "scaling down" is the specially designed plant for the assembly of radios developed by Philips N.V. of the Netherlands. The main object of this design was to develop a low cost production unit for smaller volume of output than is typical in Europe; in the process the unit also turned out to be somewhat more labour-intensive. The firm also developed simpler types of equipment which can more readily be repaired or replaced from local stocks.

Another recent example of a successful technological adaptation is the design of a mechanical cashew-nut processing plant by Oltremare, an Italian firm, for use in Tanzania. It is interesting that this design, which has radically improved the position of Tanzania in the cashew-nut market and altered the structure of its international trading relations, particularly with India, represents the displacement of a labour-intensive process by a capital-intensive process which is more efficient both from a private and social point of view.

The multinational corporation and regional co-operation

In the industrial countries one of the features of the growth of multinational corporations has been the development of production characterized by specialization and international interchange of components between affiliates of the same enterprise. Among the many examples of such arrangements involving two or more countries are the United States-Canadian automotive agreement, the production and exchange of components by International Business Machines Corporation between the United States and several European countries and among several Latin American countries, and the international operations of the Massey-Ferguson tractor company. In order to overcome the diseconomies of small-scale production of automobiles in Latin America, characterized by a proliferation of many makes and models, proposals have been made for specialization and interchange of parts in this region, although no concrete action has thus far been taken.

In one respect Africa is happier than Latin America in that it has not yet built up much manufacturing capacity based on small, high-cost production for local markets. However, there are signs of the beginning of such investment and, in the absence of co-operative arrangements among African countries, a costly round of uneconomic import substitution and the development of high-cost production of intermediate goods is inevitable. The automotive industry is perhaps the most important one now threatened with this prospect, but it affects also the electronics industry and the production of durable consumers' goods generally.

With further development of manufacturing in Africa toward complex durable consumers' goods and intermediate products, it can be anticipated that the multinational corporation may play a significant role particularly in relation to regional economic co-operation. The need of such firms for a large market in order to enjoy ecomies of scale will tend to exert pressure for regional co-operation. In this connexion, the following commentary from two observers of the African economic scene is of interest:

> "In general, it would appear that the smaller, less innovating, weaker financial, less technically efficient, more dependent on cheap labour and less involved in the African territorial economy as a whole (i.e. more enclavized) a foreign firm, the more likely it is to oppose economic integration ... It is worth underlining that the firms who have the most to offer Africa in capital, technical expertise, managerial ability, greater efficiency of operation and pioneering of new lines of economic activity are those which will tend to benefit from, and be encouraged to expand or initiate African based operations by, economic integration".1/

On the other hand, the firm's interests will naturally lend it to seek the most favourable solution for itself, combining both access to a large market and optimum location within the region from the point of view of minimizing costs. The latter consideration would dictate an unbalanced geographical distribution of industrial production from the point of view of the least developed countries within the region in the absence of governmental intervention to the countrary. This is, of course, the basis for regional co-operation in the execution of national development plans in industry as well as in other sectors.

In certain regions where the balance of comparative advantage among the countries in producing a particular product is about the same, the issue of co-operation arises from the fact that it is less a question of deviating from the optimum location than of which country will get in first, thus precluding for some time a similar investment in the country or leading to wasteful duplication of investments. In this case the multinational corporation may

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1/ See R.H. Green and K.G.V. Krishna, Economic Co-operation in Africa, Nairobi, 1967, pp. 81 - 82.

contribute to a solution if the possibility exists of specialization and interchange between the two countries. For example, in the pulp and paper industry it would be in a firm's interests, as well as in the interest of the countries concerned, for a plant in one country to specialize in one type of paper products and a plant in the neighbouring country in another, provided there is agreement to provide reciprocal access to the two markets. Still tighter integration on a regional basis may be needed in the case of an industry like the automotive industry, involving not merely co-operation in the production of components and assembly operations but also import of some components from the parent company overseas.

Relations between the multinational corporation and the host country

It can be seen from the foregoing discussion that there are a number of points at which the logic of operations of a multinational corporation may bring it into some measure of conflict with the aims of the host country.

(i) Degree of control

One issue is the degree of control over the local affiliate as measured by the portion of equity held by the overseas parent enterprise. Like other equity investors multinational corporations tend to prefer a wholly-owned subsidiary presumably on the grounds that full control gives the greatest scope for maximizing profits. However, if resistance to this degree of control is encountered they are frequently flexible and willing to accept a joint venture with a minority position. In some instances they are willing to license know-how and undertake management contracts without an equity position.

It is beyond the scope of this paper to review or appraise the many types of arrangement that may be and increasingly are being adopted in developing countries with regard to control. The possible substitution of regulation for control exercised by participation in the equity further complicates the situation. Further, the objective of increased national control, through equity participation, may conflict with financial objectives, including those relating to the balance of payments. In broad terms, the issue is: what is the alternative and how efficient is it?

(ii) Local content

In import-substituting industries an important issue may be the degree of local content (domestic value added). The host country, having in mind a developmental objective, may seek a local content which the multinational firm, with its eye on minimizing costs (particularly if there is a question of possible future export), may consider premature. This issue is not unique to the multinational corporation, since in the final analysis it involves a sound decision on the allocation of the country's resources. But the multinational firm may have a greater stake in avoiding protection of local inputs because it has its own production facilities abroad that are capable of producing at lower cost. Overshadowing these concerns, perhaps, is the importance of avoiding premature import substitution in intermediate goods which could prejudice regional cooperation and still more the export of manufactures to the world market.

(iii) Processing of exports

Conflict over the degree of local processing of exports of primary commodities derives both from private interests of business and labour in the industrial countries as well as government policy, and the two are naturally intermixed. There is also another issue relating to exports. For various reasons a multinational firm may adopt a "global" strategy for the "sourcing" of exports from its affiliates. This may mean that exports from a particular country may be restricted. It seems doubtful that this policy would be pursued over a long period if the restricted country is truly a low-cost producer and competitive in the world (or possibly regional) market, but the fact remains that, in the short run, excess capacity in one of its plants in another country may induce the multinational firm to favour that country as a source of exports. This is more likely to occur if the restricted affiliate is only a licensee or if the multinational firm's interest in it is a minority one.

(iv) Research and development

With the growth of the industrial sector, research and development activities are bound to be of increasing importance to a developing country. One aspect is the desirability of modifying product design in order to suit local conditions or tastes better. Another is the modification of the production process itself. This may involve utilization of unconventional local materials, the possible advantage of substituting abundant labour for scarce capital on the scaling down of production facilities. There are also the more routine questions of quality control, maintenance of standards and decisions regarding the purchase of equipment. In order to ensure efficient operations most multinational firms pursue a policy of centralized research and development, although this does not necessarily exclude some local R and D operations. The issue is whether this policy is in the best interest of developing countries with their special needs.

On the one hand it is argued that important research problems can be referred by the affiliates in developing countries to the centralized research and development facilities of the parent firm which not only reduces overhead costs but also permits drawing upon the experience of affiliates in other developing countries. On the other hand it is argued that this process of referral may be less efficient than having facilities on the spot. Furthermore, it is held that sooner or later a developing country must develop a national research and development capacity, and indeed that the ability to import know-how depends on this; insistence on a minimum of local research and development by multinational corporations is one means to this end.

Even if centralized research is more efficient from the private point of view, insistence on local facilities may be regarded as a form of taxation on the international firm. Related to this issue is the general question of the government's policy with respect to the support of research and development facilities. Research and development facilities are expensive in terms of capital, operating costs and scarce manpower. Experience shows that the research and development activities of private firms and the government must be related in order to be efficient. Each developing country has to determine the extent to which investment of scarce resources in research and development is justified in terms of the gain that can be derived.

(v) Over- and under-invoicing

The issue of over- or under-invoicing and other accounting practices by multinational firms as a means of evading taxation or exchange restrictions has been discussed above. Perhaps the most important aspect of this question -- apart from the question of the prevalence and extent of such practices -- is the ability of the government of the host country to deal with it effectively by its own administrative procedures. Assuming that the services of multinational firms are desired for their contribution to economic development, the strengthening of a government's administrative capacity to avoid the negative aspects of their operations is worth consideration. Two forms of international assistance would be useful here. One is technical support in strengthening national tax administration. The other, more challenging, is some form of co-operation between the tax authorities of capital-exporting and host countries.

Policy of African governments toward multinational corporations

The foregoing discussion suggests some guidelines of policy for African governments on how to negotiate and what to negotiate for in dealing with multinational corporations. They do not include all the elements of a "cost-benefit" appraisal of a potential foreign investment — including its impact on the balance of payments — but concentrate on those aspects which are of special relevance to investments by multinational corporations.

In preparing for negotiations a basic desideratum is knowledge of the various alternatives through which a particular project can be financed, organized and managed. The range extends from full ownership of a local affiliate by a multinational corporation to a joint venture with varying combinations of foreign and local equity and loan capital or to turnkey plants with management contracts and/or licensing of imported know-how. An efficient choice among these alternatives will depend on a thorough knowledge of the costs and benefits of each. Judgement will be helped by a knowledge of the experience of other developing countries in the particular branch of industry. Assistance from a competent consultant or an international organization may be helpful.

If full ownership by a multinational corporation or a joint venture is accepted, the government of the host country should be concerned with several features of the arrangement. One is the degree of local content to be required. A balance should be struck between an operation limited to "finishing touches" and insistence on uneconomically high local content. The backward and forward linkages of the project with the local economy should be thoroughly explored.

In the case of exports of primary commodities (including minerals) attention should be given to securing as high a degree of processing as feasible.

An effort should be made to encourage or require the multinational corporation to devote resources to local research and development. It should be understood, however, that such a policy is likely to be fruitful only in the context of a well formulated national policy with regard to industrial research and development.

Policy regarding the training of local personnel is another point to be covered. The evidence indicates that in their own interest multinational corporations generally conduct extensive training programmes both in the country of operation and by bringing higher level national personnel to the parent firm for training. There is much evidence that in-plant training is more effective than formal technical training in an academic atmosphere. It appears desirable, therefore, to encourage this; since labour turnover may make the private cost of such training higher than the social cost, it seems appropriate to subsidize it, perhaps by tax deductions. Since the policies and capabilities of international firms with regard to managerial systems and advancement of personnel may differ substantially it is desirable that the national administration develop some capacity to judge them.[1/]

Questions of taxation and exchange control should be watched carefully to see that intra-firm transactions are not used by the multinational corporation in a manner which conflicts with the interests of the host country. Consideration should be given to measures for strengthening the capacity of the host country to administer this area of national policy.

The formulation of the above list of considerations is not intended to suggest that a continuing detailed regulation of affiliates of multinational firms in all these matters is either logical or administratively efficient. With respect to such matters as local content, degree of import substitution and choice of technology the main issue is one of general economic policy

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1/ This is a large subject, and only a few examples may be offered by way of illustration.

With regard to managerial systems, a major object should be to reduce the need for scarce managerial skills in developing countries. An interesting effort to do this had been made by the Volkswagen Company which has developed management and procedural guides covering every aspect of vehicle manufacture and assembly in overseas plants. See Werner P. Schmidt, "The International Transfer of Management Skills — Volkswagen's Needs, Experience and Plans," in Proceedings of World Conference on International Transfer of Management Skills under auspices of Association Internationale des Etudiants en Sciences Economiques et Commerciales, (AISEC), Torino, Italy, November, 1969.

On the subject of advancement of managerial personnel, it is not surprising that different witnesses give different testimony, having different views of what is possible or acceptable. Thus, a statement by the United Africa Company says: "As soon as a local man is as competent as an expatriate the latter is bound to be replaced by the former on grounds of cost alone."

On the other hand, a recent statement by a high Nigerian official is the following: "Perhaps more important than ownership is the effective participation of Nigerian in the management of local enterprises. Even considering various difficulties - shortage of people with higher qualifications, obstacles to mobility of higher manpower - the record of local industry in training Nigerians and appointing them to positions of responsibility has been very disappointing ... A fund for industrial training ... will establish targets of progressive Nigerianization ... To speed the process the Government will mandatorily progressively reduce from year to year the expatriate quota allocations of all enterprises making due allowance for expansion and diversification ..." See "Planning for Further Industrial Development in Nigeria," by P.C. Asiodu, Permanent Secretary, Federal Ministry of Industries, Lagos, paper submitted to Conference on National Reconstruction and Development in Nigeria, Nigerian Institute of Social and Economic Research, March 27, 1969.

applying to national as well as foreign firms; it would be fallacious to focus on the specific expression rather than on the underlying cause of the problem. Several of the other points essentially concern the division of the gain between the host country and the foreign firm; as much as possible this should be dealt with by the tax system, and, where relevant, by exchange control. But in all these matters, it should be clear that the over-riding object is not merely to maximize the gain but to stimulate structural changes in the national economy.

Annex 1

Note on Costs and Benefits of Direct Foreign Investment

If a developing country is applying some form of cost/benefit analysis to investments generally (for example, for purposes of pursuing an industrialization or import-substitution policy involving tariffs or other forms of subsidy) it follows that this analysis should be applied to foreign and domestic investment alike.1/

The object of this type of analysis is to determine whether the resources used in a given project could with better effect be used in an alternative project. In addition to providing a formula for evaluating all inputs and outputs from a social rather than a private commercial point of view, this procedure also involves an attempt to measure the multiplier effect of the project on national output (but only on the assumption that the inputs would otherwise not be used or would be used with a different economic result if the project were not undertaken) and possibly also "linkage" effects of the project with local inputs and the output of the project. When this type of analysis is applied to projects financed by foreign aid it is reasonable to assume that the capital would be available for an alternative investment in the host country if a given project is rejected. In the case of a private foreign investment this is normally not the case, so the direct cost of the investment would be only the value of profits and, for analysis of the impact on the balance of payments, of remitted profits.

In applying this type of analysis to a foreign investment, the issue is to what extent the investment's impact on the host country will differ from various alternatives. From the economic point of view, this difference may be analyzed in three aspects: (1) the impact on national output; (2) the impact on the balance of payments; and (3) the impact on economic structure in the broad sense, including all aspects of the long-term productive capabilities of the host country.

1/ A recent model of such analysis is contained in I. Little & J. Mirrless, Manual of Industrial Project Analysis in Developing Countries, Volume II, Organization for Economic Co-operation and Development, Paris, 1969.

In all these respects the appraisal will differ, depending on whether, in the absence of the foreign investment, the project would or would not have been undertaken by an indigenous enterprise. If a local enterprise would otherwise have undertaken the project, the analysis would involve a judgement on the extent to which it would have relied on imported technology, management and the like as well as imported capital.

Of the three aspects of an investment's impact, it seems obvious that the impact on economic structure is the least amenable to measurement. Despite some difficulties, there is less difficulty in measuring the impact of a foreign investment on the domestic product and on the balance of payments by the use of an econometric model whose parameters can probably be estimated within tolerable limits.1/ The impact on the balance of payments consists essentially of two parts: (1) the direct effect of the initial inflow of capital and the outflow of profits; and (2) the indirect effect, consisting of (a) the net flow of foreign exchange due to the operations of the enterprise (substitution of imports, any export earnings, imports and inputs and, possibly, diversion of domestic resources from possible exports or other import substitution)2/ and (b) the impact on imports of the increase in domestic income arising from the operation of the multiplier on the initial value added by the investment.

Given the balance-of-payments difficulties faced by most developing countries, it is natural that much attention is concentrated on this aspect of foreign direct investments. It is interesting, therefore, to take note of some recent factual studies of this question. In the UNCTAD study of a sample of manufacturing firms in Kenya and Jamaica cited above, it was found

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1/ See, for example, a study prepared by a group of experts for the UNCTAD Secretariat; "Balance-of-payments effects of private foreign investment: Case studies of Jamaica and Kenya," UNCTAD document TD/B/C.3/79/Add.2, 21 May, 1970. The investigation is being extended to India and Iran.

2/ It is possible that government policies can so stimulate import substitution that the value added of an enterprise can be negative, even though it is commercially profitable, when its inputs and output are valued at world prices.

that, allowing for both indirect and direct effects and adjusting for the possibility that foreign firms might have displaced potential indigenous firms, almost all the foreign firms studied were found to have substantial beneficial effects on both the balance of payments and the national income of the host country. As regards the effect on national income, a substantial part of this reuslt is due to the assumption that, in the absence of foreign investment, domestic firms would not have come forward to produce the import substitution. However, the assumed degree of potential local replacement makes little difference to the estimated impact on the balance of payments.

A somewhat different result was obtained by other investigators by constructing a macro-econometric model of Brazil designed to test the combined effect of a large-scale process of import substitution heavily supported by foreign direct investment 1/. It was assumed that new investment for import substitution was divided between foreign investment and domestic investment in the ratio 60:40. The essence of the model is an extremely high multiplier which produces a sharp increase in national income following the investment for import substitution. Interacting with a marginal propensity to import that remains stable, but with a changing composition of imports, the higher income level produces an increased demand for imports that more than offsets the balance-of-payments gain of the import substitution effect. Profit remittances of foreign private investors who have invested for import substitution have only a negligible weight in the new balance of payments deficit in this model. Both the direct import substitution effect and the effect of profit remittances are overwhelmed by the income-creating effect of the import substitution.

This is a situation of structural imbalance which, being neither caused by nor substantially alleviated by foreign investment, obviously requires some other external source of finance if the development process is not to be frustrated.

1/ See Nathaniel H. Leff and Antonio Delfim Netto, "Import Substitution, Foreign Investment and International Disequilibrium," The Journal of Development Studies, April, 1966.

The remaining aspect of the cost/benefit relationship of foreign private investment — the impact on economic structure — is frequently intermixed with another aspect, namely the division of the gain from foreign investment between the investor and the host country. This is because governments have tended, when negotiating with foreign investors, to impose commitments designed to obtain beneficial effects on the structure of the host country, particularly with respect to training of personnel, replacement of expatriate by local personnel, research and development activities, level of domestic content (backward linkages), domestic savings and the like. Another aspect has to do with the choice of technology, the interest in which has heightened with the concern over the limited employment effects of industrial development. Apart from the evident difficulty of measuring and summing up these aspects, it has to be constantly borne in mind that the issue is to compare the impact of the foreign investment in these respects with the situation that would prevail in the absence of such investment.