How Can Official Development Aid and Foreign Direct Investment Assist Developing Democracies?

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Assisting fledgling democracies is important but also very problematic. Research on the subject has failed to produce any effective strategies or techniques to help new democracies succeed (Quigley 1997, 564-567). Many policy makers from democratic countries try to export their notion of democracy; however, they fail to realize that there is not a “one-size-fits-all” solution. Free and fair elections may not constitute a successful measure for democracy; they are a necessary yet not sufficient requirement (Quigley 1997, 564-567). It is important that policies aimed at assisting democracies not only help set up the procedural elements of democracy but also help foster substantive democratic elements such as “parties, civic groups, trade unions, think tanks, and the mass media” (Diamond 1992, 25-46, Quigley 1997, 564-567). Thus, these components must be implemented and maintained overtime to provide a stable foundation for democracy to thrive. However, the stability of these is contingent on the stability of a robust economy since the instability of the economy can change decisionmaking. Based on this assumption, it is necessary to promote the economy in order to secure democracy.

Most analysts and policy makers agree that the economy plays a key role in assisting democracy, but how it assists fledgling democracies is hotly contested. For example, researchers debate about whether a robust economy leads to democracy or if the correlation is reversed (Bois & Stokes 2003). However, researchers have found that democracies with unstable economies are at a higher risk of failure than democracies with strong economies. (Carothers 1997, 11-18, Diamond 1992, 25-46). This drives researchers to explore the causes of economic growth in order to sustain democracy.

Unfortunately, many countries lack the physical and political resources necessary for high economic growth. For example, some governments lack an efficient tax collection while others deal with infertile mountainous terrain. Most developing countries turn to international aid. Official Development Aid (ODA) can strengthen political and physical infrastructure that may help stimulate economic development. For example, financial resources can help free government officials from informal dependence on rich interest groups within the country. These officials become accountable to international governments and alliances rather than to black market leaders. ODA can also be used to construct a transportation infrastructure that can allow the free exchange of goods and services throughout the economy.

Despite the benefits of ODA, economic analysis reveals decreasing marginal returns to these investments. It is possible that ODA accumulates human and physical capital, which increases a country’s level of income but not its economic growth over time.
Foreign Direct Investment (FDI), however, has proved to stimulate economic growth and thereby democracy. Rather than governments arbitrarily transferring money to developing countries, private investment accumulates in the most efficient markets in each country. Thus, industries with a comparative advantage and economies of scale will thrive while others will redirect resources into more efficient industries.

In order to best manage these two different types of foreign investment, I argue that Official Development Aid should be refocused towards developing government and public infrastructure. In the subsequent absence of excessive corruption and bribery, Foreign Direct Investment will flow into the economy and help sustain economic growth and maintain the democracy.

**Official Development Aid**

Countries have historically used ODA to promote the both economic and social welfare of those countries. It is thus concerning that economists such as Lant Pritchett, a World Bank economist, report that development aid does not promote development. Out of the 108 countries that he studied, only eleven had a healthy GDP per capita growth rate. Forty countries had a GDP per capita growth rate of less than one percent and twenty-eight countries had a GDP per capita growth rate of less than .5 percent. Sixteen countries actually had a negative per capita GDP growth rate (Pritchett 1997, 3-17). The report suggests that development aid is not being used effectively to create development. This provides evidence that ODA may not be best fit for all kinds of economic development. In fact, it shows that it has an almost insignificant effect on the GDP per capita growth rate in many countries, and in other countries ODA may actually contribute to a decline in GDP per capita growth rate. There are several reasons why ODA does not sustain economic growth.

ODA may fail to cultivate long-term growth because it refocuses governments’ attention on immediate but less important issues while ignoring long term critical issues (Strong 1995, 233-239). This most likely occurs because ODA is given without direction or specific expectations.

First, ODA may cripple a country’s long-term growth by redirecting the governments’ accountability toward a foreign entity. In the contemporary world, democratic governments develop over long periods of time and establish accountability and trust between the government and society. This can occur as the society learns to trust successful government policies and elects representatives to office. Additionally, the government learns how to manage its budget and create sound development projects that will contribute to the country’s growth. Official Development Aid, however, may reduce the government’s accountability to citizens because they are no longer dependent on tax revenue to finance projects and thus no longer accountable to taxpayer: the citizens. Without the mutual exchange between society and government, official are more likely to be influences by outside interest groups that can also fund the government. (Alesina and Weder 2002, 1126-1126-1137, Knack 2001, 310-329). The newly achieved independence also reduces governments’ desire to institute good policies. They often redirect their efforts away from efficient policies and projects and move toward interests that may more but may do little for the economy. Some evidence reveals that ODA “fosters corruption by increasing the size of resources fought over by interest groups and
factions" (Alesina and Weder 2002, 1126-1126-1137). This can lead to inefficient policies and a deficiency in the necessary infrastructure required to attract private capital (Knack 2001, 310-329).

Other problems stem from how ODA is used by governments. Many economists argue that ODA is not effective in creating growth because the recipient government consumes rather than invests the aid in the country. More importantly, this additional disposable income allows the government to spend its original budget more frivolously (Burnside and Dollar 2000, 847-868). Thus, ODA can cause governments to get in bad habits of spending money on projects they don’t need but want to complete for less altruistic reasons. For example, many African governments receiving ODA have failed to invest their aid and have mostly inefficiently consumed it. Moreover, Victor Levy reports that the average world growth rate went from 3.7 percent in 1968-73 to 4.1 percent in 1974-80. In contrast, African countries actually experienced a decline, from 3.3 percent in 1968-73 to 3.0 percent in 1974-80 (Levy 1987, 152-156).

Despite the grim results of ODA, some researchers have found that aid can have a positive effect if given under the right conditions (Burnside and Dollar 2000). If a government has a relatively strong rule of law and stable economy, government officials are more likely to invest in effective projects and government reforms. This is likely due the economy’s stable environment which can sustain and expand capital investment. In this situation, ODA may have a positive effect.

Nevertheless, research by William Easterly shows that when Burnside and Dollar’s dataset is expanded and their regressions are rerun, the results show no correlation between ODA and growth (Easterly 2003, 23-48). Easterly’s findings confound all the recent enthusiasm about the possible gains from ODA and force policy makers to reconsider the usefulness of ODA when creating development strategies.

Some experts have suggested that a country’s environment is less important than the conditions connected with the aid. In other words, aid might be effective if connected with various conditions and incentives. However, Robert Cull finds that “country characteristics were more important than loan characteristics” and conditional aid does not increase its effectiveness (Cull 2001, 269-290). Governments promoting good policy environments are already disposed to reform, so conditional loans become a means by which they can (1) “publicly commit to policy measures,” (2) “signal to the private sector that a reform program is credible,” thus encouraging “a quicker response from investors” and (3) cultivate development (Cull 2001, 269-290). This indicates that a country’s political infrastructure and economy more importantly determine the effectiveness of development aid.

In spite of overwhelming evidence which reports ODA’s ineffectiveness, especially where governments are corrupt, Alberto Alesina and Beatrice Weder report that corrupt governments receive just as much as less-corrupt governments. This suggests that governments with a poor rule of law and unsuccessful policies are just as likely to receive aid as are less corrupt governments with successful policies. (Alesina & Weder 2002, 1126-1137). Although some countries, such as Norway and Australia, give more aid to less corrupt governments, the majority of aid still goes to corrupt governments (Alesina & Weder 2002, 1126-1137).

Official Development Aid, for the most part, fails to act as a catalyst for development. For a few countries already disposed to creating development it can help to
spur development, but for the majority of countries its effects are negligible, and for some countries aid leads to a decline in development. Additionally, sustained amounts of aid can make countries dependent on aid seriously undermining the “quality of governance and public sector institutions by weakening accountability, encouraging rent-seeking and corruption, fomenting conflict over control of aid funds, siphoning off scarce talent from the bureaucracy, and alleviating pressures to reform inefficient policies and institutions” (Knack 2001, 310-329). Conditional aid only seems to work at the margins, inducing relatively few countries to reform in order to receive aid. Countries with good policies will most likely already be developed to a certain extent so that each dollar of aid faces diminishing marginal returns.

Regardless of these unfortunate results, there are several constructive ways that donors can try to increase the benefits of aid. Stephen Knack found that highly variable amounts of aid decreases a country’s dependence on aid because the country cannot rely on it from year to year to finance its programs (Knack 2001, 310-329). Additionally, donors can “devote greater efforts to strengthen civil society and its links to government” which will most likely improve government transparency and accountability, which are usually necessary precondition for private investment (Knack 2001, 310-329). Aid can also be targeted to the “start-up of small business” making it less fungible and also helping to promote development by directly creating economic growth and indirectly promoting social development (Knack 2001, 310-329).

FOREIGN DIRECT INVESTMENT

For most developing countries and fledgling democracies, focusing on creating environments that attract private investment will directly stimulate economic growth and indirectly promote social development. Foreign Direct Investment is different than Official Development Aid because the market decides where financial resources go. Thus, the aid goes to a country’s most productive and efficient industries and is not wasted through corruption as ODA can. Typically, domestic investment is preferred to foreign investment; however, since domestic investors in developing countries often lack the funds, managerial know-how, and technology to create a successful business, governments are likely to welcome Foreign Direct Investment (FDI). Governments, then, turn to FDI to act as a catalyst for development within their country and to supplement private domestic investment (Rozental 1957, 277-285).

Do positive externalities that supposedly come from FDI really exist? Most host countries of Foreign Direct Investment (FDI) from multinational corporations (MNCs) argue that it does. Host countries for MNCs regard FDI as a “significant opportunity for integrating their economies into the global market and promoting their economic development” (Long 2005, 315-336). These countries find that FDI cultivates development through a variety of ways from providing more health coverage than domestic firms to increasing research and development within the country (Erdilek 2005, 108-133, Moss, Ramachandran and Shah 2005, 340-362). For many developing countries, FDI plays a crucial role in development.

Naturally, any research on economic growth must control for a variety of variables that may exogenously or endogenously cause growth. Additionally, studies must control for possible spurious relationships between FDI and growth. It is also hard to determine
whether FDI caused economic growth or if a spurious relationship exists. This complication of data makes it difficult to compare the effectiveness of FDI with ODA.

While it may be hard to track all the causal mechanisms for economic growth, FDI certainly plays a vital role in every country’s economy. In developed countries with large economies it is almost impossible to understand how the economy responds to policies, FDI, or domestic investment. However, in developing countries it is possible to find many connections between FDI and economic growth because developing countries usually have smaller economies. Indeed, it is important to separate developing countries from developed countries in order to discover the positive affects of FDI on economic growth (Blonigen and Wang 2005, 221-241).

When useful controls and measures are used and the data is divided into appropriate samples, empirical evidence shows that FDI does, in fact, promote economic growth, which in turn helps spur development in a broader sense. Researchers find that under the right policies and conditions an array of different positive spillovers can come from FDI. These include wage spillovers, production spillovers, technological spillovers, lower prices, higher quality domestic suppliers, and increased research and development. Not only does FDI produce positive spillovers, but for some countries it “may mean the difference between development and stagnation, in others, it may be a precondition of higher living standards” (Rozental 1957, 277-285).

An important caveat to note in the relationship between FDI and growth is that FDI has a different impact on different types of domestic corporations. Foreign Direct Investment often has a negative short-run effect on domestic competitors. Most research shows that there are few horizontal spillovers, which is why domestic competitors are crowded out in the short-run. However, Foreign Direct Investment does have a positive short-run impact on domestic suppliers (vertical spillovers) who provide MNCs with the necessary inputs for production. In the long-run FDI has a positive affect on both domestic competitors and suppliers and, to some extent, the longer an MNC is in a country the larger the positive impact of FDI will be in the domestic market (Moran, Gramham and Blomstrom 2005, 375-393). Positive externalities from FDI will most likely occur at the local level because of the close knit ties that MNCs form with domestic suppliers which are usually geographically close. The positive externalities may also spillover into other neighboring countries as former employees move and as the MNCs technology slowly diffuses throughout the market, thus increasing the development within whole regions of the world (Gorg and Strobl 2005, 137-155, Lipsey and Sjoholm 2005, 36-41). To understand how FDI effects growth one must first disentangle how FDI affects domestic markets.

One of the most important effects that come from FDI is the competition effect. Greater competition within the country’s market provides incentives to pay higher wages to attract workers, invest more in research and development, increase productivity which lowers costs for both domestic suppliers and domestic competition, and increase quality standards for domestic suppliers. According to Guoqiang Long, FDI created competition in China’s Pearl River Delta and Yangtze River Delta that helped motivate domestic suppliers and domestic competitors to improve their respective industries, and, as a result, the Pearl River Delta and Yangtze River Delta have become world-class information technology regions (Long 2005, 315-336).
Domestic suppliers immediately feel the effects of Foreign Direct Investment as MNCs demand inputs in order to produce their products. Additionally, downstream suppliers may feel the effect of FDI as MNCs demand packaging services so that they can send their finished products into the market. Many MNCs do, in fact, rely on domestic suppliers for inputs, but how much they rely on domestic suppliers usually depends on the quality of products domestic suppliers can produce (Moran 2005, 283-309). Multinational corporations often will help potential domestic suppliers meet quality requirements, such as the ISO 9000, in order to increase efficiency and profits. Many MNCs will still help domestic suppliers even if it benefits domestic competition by helping domestic suppliers achieve economies of scale. By achieving economies of scale, domestic suppliers can produce quality products at a low cost which benefits both MNCs and domestic competition (Moran, Gramham and Blomstrom 2005, 375-393). Examples of this can be found in the electronics sector. For example, QDOS Microcircuits, a Malaysian company was able to expand into the international market and become a supplier to many corporations after Motorola helped improve quality standards, thus increasing demand for their products (Moran 2005, 283-309).

As demand for inputs from domestic suppliers increases the productivity and profitability of the supply sector, the supply sector will grow resulting in increased competition as new firms enter the market. Thus, as a result of Foreign Direct Investment the supply sector is able to grow and encourage economic development.

Wages will also increase as a result of Foreign Direct Investment for three reasons. First, MNCs will enter the market and offer higher wages than the domestic competition in order to attract skilled workers. Second, as the demand for inputs from domestic suppliers increases domestic suppliers will start to demand more skilled laborers which will also increase the wage rate. Third, as domestic suppliers reach economies of scale the price of inputs will drop, the quality of inputs will go up, and profitability will increase which will cause domestic competitors to enter the market resulting in additional demands on the labor market.

Multinational corporations also help countries stay out of recessions and depressions by shifting production from areas of high cost to areas of low cost. As the cost of investing in a particular country decreases due to an economic recession MNCs will weigh production costs in other countries compared to production costs in that country. One of the characteristics of MNCs is their ability to quickly shift production from areas of high cost to areas of low cost. Investments in the country with an economic recession will rise as MNCs invest in that country and demand for labor and capital will increase. Multinational corporations can also help to decrease the severity of a recession or depression within a country that it is invested. In depressions the costs of investing for foreign firms dramatically decreases, which then increases the desire of foreign firms to invest in that country (Rozental 1957, 277-285). The increased investment then stimulates the economy and lifts it back out of the recession. Additionally, in a recession subsidies of a foreign firm that want to invest can gain access to credit through the foreign firm while domestic firms are unable to gain access from domestic banks (Blalock and Gertler 2005, 73-104).

Multinationals corporations must train new workers. These workers pick up technological and managerial know-how. When these workers leave they start up their own companies or domestic competitors pick them up by offering higher salaries.
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Additionally, MNCs will help domestic suppliers take advantage of the MNC’s technological and managerial know-how so that the domestic suppliers will efficiently produce quality products. Domestic competitors are then able to pick up technological and managerial know-how from domestic suppliers as well. Over time, then, MNCs’ technological and managerial know-how is slowly diffused throughout the market (Krause 1972, 93-103).

In order to stay ahead of the competition, MNCs and domestic competitors will invest in research and development (R&D) (Krause 1972, 93-103). Usually MNCs locate R&D centers in developed countries where there is a large skilled worker pool, but as intellectual property rights, favorable investment policies, infrastructure and the number of skilled workers increases in developing countries MNCs will shift R&D to areas of low cost (Erdilek 2005, 108-133). However, countries that choose to continue to force MNCs to participate in joint ventures or that have weak intellectual property laws will find that MNCs will not invest in R&D or use the most technologically advanced production techniques within the country (Krause 1972, 93-103).

Some countries have valid concerns that Foreign Direct Investment will crowd out domestic competition, resulting in a loss of economic development. In the short-run it appears that it is true that domestic competitors are crowded out of the market. Multinational corporations usually have advanced technology and better managerial knowledge then domestic competitors allowing them to produce better products at a lower cost. Additionally, MNCs may overwhelm domestic suppliers with orders so that domestic competitors are unable to get the necessary inputs for production. However, in the long-run domestic competitors will enter the market as domestic suppliers are able to reach economies of scale and thereby produce quality inputs at a low price, thus cutting the cost of production (Blonigen and Wang 2005, 221-241). Additionally, as technological and managerial experience diffuses throughout the market, domestic competitors will be able to capitalize on the MNC’s know-how.

It is necessary to note, though, that FDI has the largest positive effect in open markets. Countries with distorted economies will fail to initiate robust economic growth through Foreign Direct Investment (Lawrence 2005, 368-373). In fact, when there are market distortions FDI tends to have a negative affect on the host country’s economy (Moran, Gramham and Blomstrom 2005, 375-393). Governments and MNC overcompensate in a way that will count out any positive benefit. It is necessary for countries to open up their markets to MNCs in order to initiate economic development. The incentive to integrate into the international market is great because of the many potential benefits that come from FDI, including the transfer of technological and managerial knowledge (Feinberg and Keane 2005, 245-277). Multinational corporations are also increasingly demanding to be allowed to operate wholly owned facilities, so countries that refuse to open up their markets to the demands of MNCs will find that they remain undeveloped. Indeed, those countries that have forced MNCs to invest in joint ventures and share technology in order to spur development have failed to see any economic improvements (Moran 2005, 283-309). The consequences of this are quite profound and are part of the reason why MNCs are gaining considerable power in the international system. MNCs will continue to gain more power as countries begin to institute liberal economic policies in order to integrate their economies into the international market.

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In pursuit of integration into the international market and economic efficiency, states must let multinational corporations freely mobilize and deploy resources "according to the most efficient pattern" (Ball 1968, 163-170). States must, then, adopt liberal trade practices and open up their borders in order to broaden their economic horizons. However, some countries are catering too much to the needs and wants of MNCs. These countries not only open up their markets to MNC investment, but they also give out tax breaks, subsidies and free land in order to encourage MNCs to invest in their country (Moran 2005, 283-309). The power that this gives MNCs is tremendous. As a result, states have power de jure, while MNCs are gaining de facto power.

Multinational corporations gain their power over states from their ability to efficiently operate, coordinate, and manage transactions between states. In the name of efficiency MNCs can and will shift production from states with high costs to states with low costs. States, then, should be concerned with the power that MNCs have because of their ability to determine employment and, ultimately, the prosperity of the state (Ball 1968, 163-170). After all, the only thing more alarming to a state than the presence of a MNC is its absence (Sampson 1973, 288).

Additionally, MNCs political action allows them to minimize the government's ability to regulate MNCs. For example, states create property rights for individuals and groups in order to protect parties from injuring each other's property. Individuals and groups (including foreign and domestic firms) constantly vie for more protection and freer access to resources. Successful firms are then able to manipulate legislation, raising the "transaction costs of others" which allows them to "exploit the ensuing rents" (Boddewyn 1988, 341-363).

The rise of the MNC has also created, in effect, an international organization that can have an immense effect on not only the economy, but on a state's government as well. It is always interesting to note, for example, that fifty-one of the world's hundred largest economic entities are corporations and not countries, or that "the 500 largest corporations account for 70 percent of world trade" (Kaplan 1997, 55-80). Corporations not only have the political power to influence states, but also the economic clout to devastatingly affect a state's economy should the state try to oppose a multinational corporation. It is not surprising, then, that states feel unable to formulate effective economic strategies or to plan for the future (Walters 1972, 127-138).

Despite the erosion of state power by multinational corporations, and the fact that they can act independently of states, states still have some power over MNCs. After all, states still have the right to give legitimacy and to take it away. It is therefore necessary that states remind corporations of this power, forcing MNCs to constantly stand on hostile ground.

CONCLUSIONS AND IMPLICATIONS

The evidence suggests that while ODA spurs economic growth in stable political and economic environments, it mostly contributes to economic stagnation and government corruption. On the other hand, FDI has been most effective in stimulating economic growth in developing countries. However, FDI also can have negative effects if operating in an environment with protectionist policies. In this situation, few MNCs are allowed to invest in the country however they will institute inefficient practices which will
hamper the state’s development. MNCs may also lobby and manipulate the government to keep the protectionist measures in place so that they can reap the profits from a distorted market. For example, though Chrysler used incredibly outdated and inefficient practices in Mexico, it fought to keep the protectionist policies in place “in order to preserve what its managers described as a ‘cash cow’” (Moran 2005, 283-309). Additionally, Hewlett-Packard, Compaq, Apple, and other high-tech foreign investors fought to keep Mexico’s protectionist policies in place. Mexico’s protectionist policies kept competitors out of the market allowing the MNCs to sell two- to three-years-old computer technology in the local market at prices “130-170 percent of the external price” (Moran 2005, 283-309). As previously stated, MNCs are profit maximizing entities. However, MNCs don’t always maximize profits by using the most technologically advanced equipment.

It is important to note, though, that MNCs’ investments look for more than only inexpensive labor (Moran 2005, 283-309). While MNCs want to maximize profits, they are not motivated to exploit every country’s resources and legislation. FDI is usually only motivated by first, resource-source seeking MNCs that want access to either natural resources or human capital; second, market-seeking MNCs that want access to larger markets; and third, efficiency-seeking MNCs that believe that by networking businesses across national boundaries they can lower the total cost of producing a product (Stopford 1998-1999, 12-24). An MNC’s investment strategy is much more complex then simply trying to exploit a country’s resources and legislation, especially considering that MNCs must secure and maintain their legitimacy within a country.

It is important, then, that developing democracies not only attract foreign FDI, but also institute good policies that will create an environment in which FDI can be used to foster development. ODA could be used to help developing democracies create such environments and mitigate the negative externalities that come from FDI. Well planned projects could help strengthen government institutions, increase transparency and accountability, and develop the necessary infrastructure that investors look for when deciding where to locate. Additionally, ODA could be aimed at creating an educated workforce so that technological spillovers can occur within that country.

Some researchers worry that the growing reliance on FDI will make developing countries unable to create effective programs to protect themselves (Tanzi 2001, 78-79). These researchers argue that states will be unable to institute social safety nets because they will be unable to tax FDI. States will be unable to tax FDI because states have to compete for investment. States that impose taxes or other similar measures will find that they are passed over by MNCs because MNCs are sensitive to tax incentives. Additionally, some countries give away free land as well as give subsidies to MNCs that invest in their countries, which further reduces the amount of money available for governments to allocate to social safety nets. MNCs also evade taxes through international trade between subsidiaries. Through international trade between subsidiaries, MNCs are able to transfer profits from high-tax countries to low-tax countries, thus frustrating states’ attempts to tax MNCs (Tanzi 2001, 78-79). ODA could fill this funding deficiency, allowing countries to reduce taxes in order to attract FDI while at the same time create social safety nets to protect citizens that will be negatively affect by FDI.
ODA aimed at the projects and institutions previously mentioned will most likely spur development by directly helping countries grow economically and indirectly promoting social development. As the economy grows and social environment develops citizens will become more interested in government because the government impacts their lives. As citizens explore their new found freedoms and enjoy their economic success they will seek to keep the status quo by insuring that the right institutions are in place within the government. As the citizens in the country become more actively involved in the government the, fledgling democracy will transition from a procedural democracy to a healthy, substantive democracy.

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