Sarbajit Chaudhuri
Ujjaini Mukhopadhyay

# Foreign Direct Investment in Developing Countries

## A Theoretical Evaluation

Springer

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*This book is dedicated to Shilabati Chaudhuri.*
*She is no more, but her memories remain.*

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# Foreword

With the inflow of FDI in developing countries picking up at a remarkable pace throughout the world, and the respective governments showing overwhelming enthusiasm in attracting FDI, it becomes necessary to ascertain the pros and cons of such inflows. Generally, it is believed that FDI is beneficial for a developing country and it may push the economy to higher growth orbits. However, developing countries are characterized typically by dualism and a host of market imperfections. In this situation, the favourable effects of FDI can hardly be guaranteed. In fact, a number of trade and development economists contend that FDI may lead to deterioration of welfare of the host country in the presence of tariff protection. It is important to determine the effects of FDI not only on overall welfare but on the labour market and other socio-economic issues.

Many of the above issues have been studied empirically by different researchers. Nonetheless, a detail theoretical analysis is vital to enable a clear understanding of the interactions of FDI with other variables, particularly in the presence of other types of liberalization policies. Though these issues have been addressed by different researchers in different papers, a comprehensive book dealing with the analytical and theoretical explanation hardly exists. This book will hopefully fill the gap since it incorporates the effects of FDI after introducing different kinds of distortions that developing countries are rampantly plagued with, like imperfections in the labour market, capital market and product market. It considers the cases where FDI enters the export sector as well as the import-competing sector. Other characteristics typical in developing countries like labour market segmentation, with the existence of skilled/unskilled labour, male/female labour and child labour have also been taken into account. Thus, although not exhaustive, the authors try to integrate FDI within most of the existing economic systems to find out its much-debated role in developing economies. The book is expected to be helpful not only to students and researchers but will help policy makers as well.

The senior author of the volume is a prolific researcher who has extensively published in reputed journals on these issues. Sustained commitment to this type of research is reflected in the extensive and intensive coverage of the book. The volume, in my opinion, will be a significant addition to the existing literature.

Reserve Bank of India Professor of Industrial Economics Sugata Marjit
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# Preface

Foreign direct investment (FDI) is traditionally considered in development literature as instrumental for economic growth of countries, particularly the developing ones. It acts as a panacea for breaking out of the vicious circle of low savings–low income and facilitates import of capital goods and advanced technical knowhow. The worldwide globalization drive in leading to liberalization of foreign capital regimes has resulted in a spurt in the presence of multinational corporations. The growth rate in absorbing FDI has been so fast during the recent years that in 2012, the developing economies have attracted more FDI flows than the developed economies accounting for 52 % of global FDI flows (UNCTAD 2013).

With FDI gaining so much prominence in the backdrop of liberalized investment policies, the welfare of developing economies ought to be significantly affected. Besides, these countries are subjected to phenomenal multi-dimensional impact on a host of other economic, social and environmental variables. The remarkable enthusiasm among developing countries to attract FDI, coupled with empirical results often contradicting the general contention of favourable effects calls for a close inspection into the diverse aspect and consequences of FDI on the host economy. A *theoretical* analysis of the different facets of FDI is indispensable, especially for formulation of appropriate policies for foreign capital.

In this book we attempt to delve into the complex interaction of FDI with different other factors. While FDI boosts up the efficiency of domestic producers, it impinges on the labour market affecting wages, unemployment levels, and wage inequalities on the basis of skill and gender; it also has important implications on the socio-economic issues like child labour, agricultural disputes over special economic zones (SEZ) and human capital formation through externalities. The empirical evidences with regard to most of the effects of FDI are highly mixed and reflect the fact that there exist a number of mechanisms that interact with each other producing opposing results. We try to provide the theoretical underpinnings behind

the inherent contradictions and show that the final outcome depends on a number of country-specific factors like endowments of other production, technological, and institutional factors.

We give an outline of the established doctrines relating to FDI and elucidate on the newer ones to trace the nature and direction of desirable policy parameters that may be relevant in the present scenario. We incorporate the effects of FDI within the traditional Heckscher-Ohlin model and introduce different kinds of distortions that developing countries are rampantly plagued with, like imperfections in the factor markets and product market and presence of non-traded goods. We consider the cases where FDI enters not only the export and import-competing sectors but also the intermediate and services sectors. Other characteristics typical in developing countries like labour market segmentation, with the existence of skilled/unskilled labour, male/female labour and child labour have also been taken into account. Thus, although not exhaustive, we have tried to integrate FDI within the important existing economic systems to find out its much-debated role in developing economies.

Although a number of theoretical articles relating to FDI have been published in different journals, very few books address all the issues and dimensions related to FDI comprehensively in a simple theoretical and formal framework, as we do here. The major part of the book is based on Chaudhuri's own, and sometimes collaborative, research, carried out in Kolkata, India and published in different international journals over the last decade and a half. Throughout the book we have used the simple 'hat calculus' developed and popularized by R.W. Jones in his two seminal articles, Jones (1965, 1971). We felt the necessity to discuss in detail on extensions of the simple two-sector general equilibrium models, inclusion of non-traded goods and factor market imperfections and the techniques of measuring social welfare in a small open economy. All these give a future economist a thorough idea how simple general equilibrium models can readily be used to analyze different complex problems pertaining to the developing world and to suggest remedial measures based on findings of the theoretical models. The contents of the book can be a part of a course on trade and development at the postgraduate level. These can as well be a small part of a course on labour economics in universities in the developing world. Although the book is primarily intended towards postgraduate students and researchers who are pursuing theoretical research on trade and development, it is also aimed at suggesting alternative policies to policymakers in the developing nations for application to development projects.

The book was written over a period of more than 3 years. It was first, Sagarika Ghosh, Senior Editor, Springer (India) who came up with a proposal of writing a book based on policy-oriented theoretical research on the developing economies like India. After satisfactory progress in the first 2 years, Chaudhuri fell seriously ill and was practically out of his academic activities for several months. At that time, it looked impossible that the book could ever be completed. After his recovery Chaudhuri could finally complete the work at least to his satisfaction. He wishes to express his heartfelt gratitude to Profs. Sarmila Banerjee, Mahalaya Chatterjee and other colleagues at the Department of Economics, Calcutta University, and, to

his former student, Dr. Jayanta Kumar Dwibedi, for their kind help during the most difficult phase of his life. He would like to thank Dr. Vivek Benegal, Dr. Deepak Jayarajan and other medical practitioners for the successful treatment he received at NIMHANS, Bangalore, India, which cured him and was instrumental in his return to normal academic life.

We express our indebtedness and gratitude to the people who have helped in shaping this book in one way or the other. Chaudhuri wishes to express his intellectual indebtedness to Profs. Sajal Lahiri, Manash Ranjan Gupta, Sugata Marjit, Shigemi Yabuuchi, Krishnendu Ghosh Dastidar, Ronald W. Jones, Kaushik Basu, Partha Sen, Abhirup Sarkar, Subhayu Bandopadhyay, Hamid Beladi, Arup Mallick, Ajit Choudhury, Soumyen Sikdar and Dr. Saibal Kar. His interactions with them either face-to-face or through electronic route have helped him immensely in understanding the applications of the simple general equilibrium models to trade and development. We are also indebted to our teachers at the Department of Economics, Calcutta University, for kindling our interest in the subject matter of economics. The senior author would also wish to thank Profs. Indrajit Ray, Arijit Mukherjee, Kausik Gupta and Dr. Biswajit Mandal for their continuous academic help over the last several years. He is also deeply indebted to his former doctoral students, Jayanta Kumar Dwibedi, Dibyendu Banerjee and Titas Kumar Bandopadhyay, and, to his wife, Pampa Chaudhuri, for helping him in the correction of proofs of the book. Thanks are also due to the publishers of different journals which allowed us to reproduce modified versions of some of our published papers. We appreciate the co-operation extended to us by Sagarika Ghosh, Senior Editor, Springer (India).

Finally, Chaudhuri wishes to thank his wife, Pampa, and daughter, Salonkara, for their inspiration to persevere under difficult times. He is grateful to his parents for their spiritual support. Mukhopadhyay would like to express gratitude to her husband, Dr. Ratnakar Pani and daughter, Mayurakshi, for their continuous encouragement and support. She remembers her parents who are no more, with deep gratitude, but whose blessings and guidance have been the motivating force behind her academic activities.

Kolkata, India
10th March, 2014

Sarbajit Chaudhuri
Ujjaini Mukhopadhyay

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**Ujjaini Mukhopadhyay** is an Assistant Professor with the Department of Economics at Behala College, Kolkata, India. She obtained her Ph.D. from Calcutta University, India, in 2005, working under the supervision of Prof. Sarbajit Chaudhuri. Her papers have been published in reputed journals such as *Journal of International Trade and Economic Development, Energy Policy, The Environmentalist, Review of Urban and Regional Development Studies*, to name a few. She has also co-authored a book titled *Revisiting the Informal Sector: A General Equilibrium Approach* (Springer, New York). Her current research interests include development economics, labour economics, and environment management.



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