# FOREIGN DIRECT INVESTMENT AND ITS CONTROVERSY: A BRIEF REVIEW

BY **ARIS SETIYANTO**

From a philosophical and ideological perspective, it seems that the presence of FDI will be more likely to be opposed. They stressed the need for national control over domestic economic activity. Many observers argue that multinational corporations can use their economic power to influence government policies at all levels.

Foreign direct investment (FDI) has become an integral part of the international economic system and is widely believed to be one of the main catalysts for the development of developing countries. Generally considered that FDI not only creates capital accumulation for the domestic economy, but also brings positive externalities through the adoption of new technologies, managerial skills, ideas, and knowledge of developed countries. Recently, many developing countries are increasingly liberalizing their economic policies to attract foreign investment through various incentives, as well as discussing how to best maximize the benefits of a foreign presence for the domestic economy. Yet is attracting FDI as broadly as possible into the domestic economy is the right policy?

In the scholar of investment as a determinant of economic growth, the discussion of the impact of FDI on the domestic economy generally leads to two perspectives. First, in the perspective of financial flows, and second, the flow of knowledge (technology transfer) that accompanies capital. In general, experts agree on this point since the flow of foreign capital (especially investment in the form of greenfield investment) will directly affect output by increasing the capital stock in the form of establishing factories and equipment in the country. In the latter, FDI can increase the productivity of human resources by providing human development training and skill acquisition for domestic partners.

However, discussions about the impact of FDI on the domestic economy are still being debated. Skepticism about the impact of FDI leads us to two important questions. First, does FDI have a positive impact on domestic capital accumulation, and therefore economic growth? Second, does FDI bring positive externalities to the domestic economy through technology transfer from developed countries to developing countries?

So far, the empirical evidence regarding the impact of FDI on the domestic economy has varied. The results of cross-country studies in developing countries revealed that the benefits of FDI on economic growth are restricted by local conditions, including stock of human capital and financial deepening in the host country. Borensztein et al., (1998) stated that FDI contributes a relatively larger contribution to growth than domestic investment if there is adequate absorption capacity in the host economy. While Alfaro et al., (2010) stated that FDI will lead to higher additional growth in financially developed economies compared to those that are less financially developed. On the other hand, Herzer, (2012) states that cross-country differen-

**The common practice of transfer pricing by MNCs that is cannot be controlled by the host government. This practice often becomes a source of hostility between MNCs and host governments, not least because it may be used for tax evasion.**

ces in per capita income, human capital, openness, and financial market development cannot explain cross-country differences in the growth effect of FDI. Instead, the growth effect of FDI is positively related to freedom from government intervention and freedom from business regulation. Various further studies provided different conclusions regarding the impact of FDI on economic growth in developing countries.

In the perspective of FDI as a channel of technology transfer, while many cross-country studies failed to provide evidence of technology transfer (Alfaro et al., 2010), a study by Blalock & Gertler (2008) on managerial and statistical cases in Indonesia report evidence that MNCs strategically transfer technology to local suppliers. Likewise, research by Djulius (2017) on manufacturing companies in Indonesia. Djulius found that export orientation by domestic companies could be a catalyst for various types of knowledge spillover from foreign companies to domestic companies.

Apart from many studies on the positive impact of FDI on the domestic economy, the presence of FDI is also opposed by several circles. While the proponents of FDI are based on neoclassical and endogenous growth theories that focus on investment and technology as determinants of economic growth, the opponents of FDI generally base on the fundamental meaning of the presence of foreign investment in the process of economic and social development in developing countries.

Furthermore, other economists are skeptical about the impact of FDI on the domestic economy. Instead of generating more investment from domestic sources by encouraging new investment from upstream to downstream (crowding-in effect), FDI can lead to the "crowding-out" effect when the presence of multinational corporations (MNCs) displaced domestic producers because of their dominance in the local market. The entry of MNCs can increase competitive pressure for local companies or pre-empting their investment opportunities. According to Jude (2019), with lower marginal costs due to their specific advanteges, MNCs capture a part of domestic demand, forcing local firms to reduce output and thereby increase their average cost. Therefore, local companies that are not competitive and are unable to renew their capital structure will be eliminated.

Mitigation of the impact of FDI on domestic investors needs to be a concern for policymakers. Agosin & Machado (2005) argue that if foreign investment enters a sector where there are competitive domestic firms (or firms that are already producing for export markets), it can eliminate investment opportunities for domestic entrepreneurs. Moreover, they state that FDI and domestic investment will complement each other when FDI enters underdeveloped economic sectors (due to technological factors or lack of knowledge about foreign markets).

From a philosophical and ideological perspective, it seems that the presence of FDI will be more likely to be opposed. They stressed the need for national control over domestic economic activity. Many observers argue that multinational corporations can use their economic power to influence government policies at all levels. As described by Todaro & Smith (2015), with the power of capital and the support of developed country governments, they have obtained some economic and political concessions from developing country governments. Although those FDI proponent tend to come from free-market flows, the actual operations of MNCs tend to be monopolistic. Pricing tends to result from international bargaining and in some cases, it results from collusion than free-market mechanisms. As a consequence, the MNC's benefits may well outweigh its social benefits. In extreme cases, they will gain control of local assets and

employment and exert considerable influence over political decisions. As happened in Chile in the 1970s, where MNCs were involved in bribery to public officials or indirectly through donations to political parties. We certainly keep in mind that the first very liberalistic policy since the start of the New Order climate to attract foreign investment was Law Number 1 of 1967 concerning Foreign Investment. In Lindblad (2015), the establishment of the law was part of the agreement with the IMF, and worth noting that the first major contract under the law was Freeport.

Even more, the common practice of transfer pricing by MNCs that is cannot be controlled by the host government. This practice often becomes a source of hostility between MNCs and host governments, not least because it may be used for tax evasion. They can avoid local taxes in high-tax countries and shift profits to subsidiaries in low-tax countries by artificially increasing the price paid for intermediate products purchased from subsidiaries in other countries thereby lowering locally generated profits. Thus, their contribution to government revenues is much smaller than it should be.

On the environmental aspect, with significant financial, political, and negotiating power, MNCs can get away with it and cause a lot of environmental damage. This mainly occurs in developing countries where environmental standards are low. Indeed, one of the reasons why they are locating production facilities in developing countries is to pursue less stringent environmental requirements (Moosa, 2002). It is noteworthy that MNC is not in the development business. Their goal is to maximize return on capital. They seek the highest profit opportunities and ignore issues such as poverty, economic inequality, employment conditions, and environmental issues.

Although the discussion of pros and cons reflects contradictions from different points of view, generally can be accepted that FDI can be an important stimulus for development as long as the interests of the MNC and the host government are aligned. Although in actuality, maybe there will never be a convergence between the interests of maximizing MNC profits and the development agendas and priorities of developing countries.

On the political aspect, many analysts suggest the need for a stronger bargaining position of the host country, more actively seeking other parties that provide better deals, as well as increasing domestic ownership and control or reducing the scale of growth of foreign investors. To reduce the negative impact on local investors, the government can direct the entry of FDI to underdeveloped sectors (Agosin & Machado, 2005), or sectors that are national development priorities. In addition, Herzer (2012) suggests that the government needs to eliminate dependence on natural resources by diversifying the economy to be able to protect developing countries from the negative consequences of FDI and encourage growth triggered by FDI in the long term. ●

---

**References**


Agosin, M. R., & Machado, R. (2005). Foreign investment in developing countries: Does it crowd in domestic investment? Oxford Development Studies, 33(2), 149–162. https://doi.org/10.1080/13600810500137749

Alfaro, L., Chanda, A., Kalemli-Ozcan, S., & Sayek, S. (2010). Does foreign direct investment promote growth? Exploring the role of financial markets on linkages. Journal of Development Economics, 91(2), 242–256. https://doi.org/10.1016/j.jdeveco.2009.09.004

Blalock, G., & Gertler, P. J. (2008). Welfare gains from Foreign Direct Investment through technology transfer to local suppliers. Journal of International Economics, 74(2), 402–421. https://doi.org/10.1016/j.jinteco.2007.05.011

Borensztein, E., De Gregorio, J., & Lee, J. . (1998). How does foreign direct investment affect economic growth? Journal of International Economics, 45, 115–135.

Djulius, H. (2017). Foreign Direct Investment and Technology Transfer: Knowledge Spillover in the Manufacturing Sector in Indonesia. Global Business Review, 18(1), 57–70. https://doi.org/10.1177/0972150916666878

Herzer, D. (2012). How Does Foreign Direct Investment Really Affect Developing Countries' Growth? Review of International Economics, 20(2), 396–414. https://doi.org/10.1111/j.1467-9396.2012.01029.x

Jude, C. (2019). Does FDI crowd out domestic investment in transition countries? Economics of Transition and Institutional Change, 27(1), 163–200. https://doi.org/10.1111/ecot.12184

Lindblad, J. T. (2015). Foreign Direct Investment in Indonesia: Fifty Years of Discourse. Bulletin of Indonesian Economic Studies, 51(2), 217–237. https://doi.org/10.1080/00074918.2015.1061913

Moosa, I. A. (2002). FOREIGN DIRECT INVESTMENT Theory, Evidence and Practice. Palgrave, N.Y.

Todaro, M. P., & Smith, S. C. (2015). Economic Development (Twelfth Edition). Pearson.