EVALUATING DIRECT FOREIGN INVESTMENT IN LATIN AMERICA

by

Shane J. Hunt

Research Program in Economic Development
Woodrow Wilson School
Princeton University
Princeton, New Jersey

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Social and political attitudes toward foreign participation in Latin American economies are changing fast. Since these attitudes are the foundation from which government policy is made, policies are also changing, although with a lag. This paper addresses the challenge that faces every Latin American country in reassessing its policies regarding direct foreign investment. The first part reviews techniques for assessing the costs and benefits of foreign investments, discussing both arguments that are customarily given, and arguments that ought to be given. It begins with evaluation techniques that take a narrowly economic focus, and continues by broadening out to cover externalities and psychic costs not easily handled with the economist's tools. The final section of the paper hazards some judgments as to how evaluations will be made by Latin American countries in coming years.

ECONOMIC EVALUATION OF FOREIGN INVESTMENT

The simplest view of foreign investment comes from traditional neoclassical analysis, which treats of only two factors of production -- labor and capital -- and views foreign investment as an addition to the capital stock in the domestic economic system. If we assume the conditions dearest to the heart of the economic theorist, that markets are competitive and changes are marginal, then an increment to foreign owned capital causes gross domestic product to increase, but that increase is the marginal product
of newly introduced foreign investment and is paid to the foreign owners of the investment. Therefore, factor payments to nationals -- GNP -- remain what they had been previously.\(^1\)

The assumptions necessary for arriving at this negative conclusion regarding the contributions of foreign investment are obviously highly restrictive, so much so that the result cannot be considered to represent a real world situation. Nevertheless, this approach performs the only function that should be expected of models of perfect competition: to make us rethink assumptions and not take conventional wisdom for granted. In the case of foreign investment, conventional wisdom suggests that it is a Good Thing, because foreign investment brings jobs and progress. It is perhaps more valid to start from the conventional wisdom of perfect competition, which says that foreign investment will take away from a country as much as it contributes to domestic output.

The conventional wisdom of perfect competition should also remind us that foreign investment is more favorable to the recipient country if capital can be obtained at rental rates below the marginal product of capital in the domestic economy, e.g., through bond financing or bank borrowing at fixed interest rates.

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\(^1\)This conclusion is overturned if the increment to foreign capital is so large that payments to capital are driven down and payments to labor raised throughout the economy. If some portion of the preexisting capital stock was foreign-owned, then payments to local labor are raised partly at the expense of preexisting foreign capital, and GNP rises. GNP also rises by a "welfare triangle" equal to one-half the change in marginal product of capital times the increment of foreign capital. These points are elaborated in G. D. A. McDougall, "The Benefits and Costs of Private Investment," in American Economic Association, Readings in International Economics (Homewood, Ill.: Irvin, 1968), pp. 172-194. A similar analysis has been applied to emigration of labor -- the brain drain. See R. Albert Berry and Ronald Soligo, "Some Welfare Aspects of International Migration," Journal of Political Economy, September/October 1969, pp. 778-794.
or through levying taxes on the foreign company's profits in a situation where the whole tax cannot be shifted. Also, the gain to the domestic economy is all the greater if wage payments by foreign firms are above the domestic opportunity cost of labor.

THE FOCUS ON BALANCE OF PAYMENTS

In recent years the purely economic evaluation of foreign investment has been conducted not by comparing increments to output with payments to foreigners, but rather by focusing exclusively on balance of payments effects. The thrust of the argument is by now well known. It has appeared in a variety of published articles and speeches, including the statement made by Chile's Minister of Foreign Affairs Gabriel Valdez upon presenting the Consensus of Vina del Mar to President Nixon.\(^2\) It generally focuses on three items in the balance of payments: long-term capital inflow, long-term in the balance of payments: long-term capital inflow, long-term capital outflow through amortization and repayment of indebtedness, and outflow of profits and interest payments from Latin America to the rest of the world. For nearly any time period chosen, the result is the same: outflows exceed inflows. The mild criticism of this situation holds that foreign investment has contributed nothing to the Latin American economies. The more severe interpretation states that foreign investment has "decapitalized" those same economies.

\(^2\)Private investments have meant, and mean today for Latin America, that the amounts that leave our continent are many times higher than those that are invested in it. Our potential capital is diminishing while the profits of the invested capital grow and multiply at an enormous rate, not in our countries but abroad." Partially quoted in *The New York Times*, June 12, 1969, p. 1. Other references to this argument include Teotonio dos Santos, "Foreign Investment and the Large Enterprise in Latin America: The Brazilian Case," in James Petras and Maurice Zeitlin, eds, *Latin America: Reform or Revolution?* Greenwich, Conn., 1968, pp. 441-442; Keith Griffin, *Underdevelopment in Spanish America*, London, 1969, pp. 143-147.
This statistical argument is, however, almost devoid of interpretative significance. Any given investment, by the time it is fully amortized, will return an outflow greater than its original inflow even if it pays the foreign investor only one percent annually on invested capital, yet such a return could hardly be considered excessive. In fact, a net inflow favorable to the Latin American balance of payments would create its own problems, as it would indicate increasing foreign influence and greater Latin American economic dependence.

This approach to balance of payments analysis contains a glaring omission in its failure to consider foreign investment effects on the merchandise account. Foreign investment earns dollars by producing exports and saves dollars by producing import substitutes, so its net balance of payments effect must include these contributions as well. The case of import substitutes presents severe measurement difficulties, however, both became domestically produced goods are never perfect substitutes for similar imports, and because the quantity of imported intermediate product required to sustain domestic production can be estimated only through the statistical imperfections of an input output table. Different assumptions on these matters lead to drastically different results. 3/ The most recent study of this nature, done by Herbert May under the sponsorship of the Council for Latin America, assumed replacement of an equal physical amount of imports, but also assumed the c.i.f. value of replaced imports to be only two thirds of domestic manufacturers'
sales. These assumptions lead to the conclusion that the most important balance of payments effects are accomplished through the merchandise account, and that direct foreign investment makes a strongly positive contribution to the Latin American balance of payments.

This exclusive focus on the balance of payments could lead us to the unsettling conclusion that a dollar's worth of exports, for which domestic factors of production must be used, are as valuable in a country as a dollar's worth of capital inflow or a dollar received as a gift. But the curious truth of the matter is that hardly anybody is interested in pure balance of payments effects anyway. When Latin American critics of direct foreign investment complain that foreigners have invested X over a given time period and taken out 2X, their fundamental concern, I think, has been with the rate of profit earned by foreign investment, a concern that such profit is in some sense excessive. Not having access to profit statistics, they have couched their arguments in terms of the balance of payments, and poorly at that, doing a disservice to themselves as well as to their readers.  

Herbert May


5 "Foreign capital retains control over the most dynamic sectors of the economy and repatriates a high volume of profits; consequently, capital accounts are highly unfavorable to dependent countries." Tantonio dos Santos, "The Structure of Dependence," American Economic Review, May 1970, p. 233. In some cases, however, balance of payments effects are so lopsided as to give good indication of excess profits. For example, repatriated profits of foreign nitrate companies are said to have reached fully 7 percent of Chile's gross domestic product during 1880-1930, yet the foreign capital inflow induced by the nitrate boom was insignificantly small, the major foreign entrepreneurs having borrowed Chilean funds through local banks. See Markos Kamalakis, "The Role of Government in the Resource Transfer and Resource Allocation Process: The Chilean Nitrate Sector, 1860-1930," in Gustav Ranis, ed., Government and Economic Development, New Haven, 1971, esp. p. 195.
and the Council for Latin America have picked up the argument and hoisted Latin American critics on their own petard. It would, however, be equally fallacious to argue that favorable balance of payments effects produced by direct foreign investment imply that such investment has been beneficial and desirable. May's report should help put a permanent finish to arguments couched in terms of the balance of payments, and oblige us to turn directly to the overriding concern: excess profits.⁶

THE CONCERN OVER EXCESS PROFITS

Critics of direct foreign investment have stayed away from the study of profit rates because reported profit rates are low and seem reasonable. For example, the battery of numbers reprinted in Magdoff's Age of Imperialism draws heavily on data of the U.S. Department of Commerce, yet not once does it make reference to Commerce data on profit rates.⁷ Nevertheless, Commerce data are the standard source, virtually the only source, for this crucial statistic. They show U.S. earnings in Latin American manufacturing to have averaged 10.7 percent of capital invested during 1960-1970.⁸ This figure is higher than the 3.3 percent earned by investments in Canada during the same period, but lower than the 12.8 percent earned in Europe. All these figures are very similar, however, and not different from the average return of 11.0 percent reported on domestic operations in the United States.⁹ From the viewpoint of Latin America, a region accustomed to high interest rates even when inflation is not proceeding apace, these rates must appear low and reasonable, certainly not the source of criticism on exploitation.

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⁶ May, op. cit., p. 20.
In the last few years, however, we have come to realize how totally unreliable these Commerce Department figures are. Not because the reporting companies lie; it is fairly well accepted that multiple sets of books are too confusing and dangerous for a large company to maintain. To be sure, suspicions have existed for some time that profits have been transferred out of Latin American countries by arbitrary over-pricing of technical services and royalties sold by the U.S. parent to its Latin American subsidiary. But in the absence of solid data the magnitude of such transfers has remained unknown, and fait de mieux Commerce data have retained their respectability.

This respectability has been jolted by revelations in Colombia, where the government put the following problem to its economic planners: Why did American companies operating in Colombia report such low profits, the Colombian government asked, when at the same time they seemed so intent upon expanding their Colombian operations? The problem devolved upon Constantine Vaitsoos, who set about a massive task of data collection that obliged him to examine a large sample of economic transactions between foreign parent companies and their Colombian subsidiaries. This included not only royalty payments and technical assistance consultations, but also valuations of raw materials and semi-finished products purchased from the parent and imported into Colombia for final processing.\(^\text{10}\) For each

such purchased input, Vaitos compared the transfer price charged by parent to subsidiary with world market prices for precisely the same commodity. The table below shows the results.\(^{11}\)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Average Rate of Overpricing</th>
<th>Declared Profits</th>
<th>Effective Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharmaceutical</td>
<td>155%</td>
<td>6.7%</td>
<td>79.1%</td>
</tr>
<tr>
<td>Rubber</td>
<td>40</td>
<td>15</td>
<td>43</td>
</tr>
<tr>
<td>Chemical</td>
<td>25-1/2</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Electronics</td>
<td>17</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

In the pharmaceutical industry, for example, a chemical input selling for $100 or the world market was, on the average, sold by parent to Colombian subsidiary for $255. Systematic overpricing of this sort served as a convenient means for removing undeclared profits from Colombia. In the most extreme case, foreign firms in the pharmaceutical industry declared annual profits of 6.7 percent on the value of invested capital, but their total effective return turned out in fact to be 79.1 percent per year. Some 80 percent of the extra profits accrued through overpriced inputs, royalties and consultant fees turned out to be substantially less important.

Vaitos' results are a dramatic consequence of an increasingly widespread phenomenon: A large portion of world trade today is conducted between various branches of the same multinational corporation, and pricing assigned to such trade is arbitrary, serving merely to shift profits about and permit them to be realized in any country of the corporation's choosing. Generally profits shifted out of one country reduce tax liabilities there only.

\(^{11}\) Ibid, pp. 34, 59-62. Effective profits expressed as percent of net worth, with capital valued in constant dollars. Two electronics subsidiaries that declared profits of minus 18% and plus 11.4% were estimated to have earned effective profits of 7% and 50-80% respectively.
to increase liabilities in some other country, so tax gains from such transfers are negligible. However, high profits may be shifted out of Latin American countries to evade regulations concerning profits remissions as well as to avoid the political embarrassment of showing that certain foreign companies are making a killing.

It is difficult and dangerous to generalize from the Vaitsos results alone. The pharmaceutical industry is notorious in the United States as well as in other countries for its high profits and deceptive competitive practices. Nevertheless, there are other pieces of evidence available, each one amounting to little more than casual empiricism, but accumulated together they substantiate the impression of high profit rates. For example, regarding payback periods required by investors in Latin America, I have head the following figures quoted, mostly by businessmen: for automobile factories, two and one-half years; for a major durable goods producer, three years; for American clients of a major U.S. bank, three and one-half years. These payback periods imply that required annual gross profits, including depreciation, are 40 percent, 33.3 percent, and 28.6 percent of invested capital respectively. If we assume that the length of life for invested fixed capital averages 20 years, then annual depreciation would amount to 5 percent of the original investment, and the gross profit estimates should be reduced by five percentage points to arrive at estimates of net profit rates. Another similar estimate comes from a RAND Corporation study of Colombia, which estimates the profit rate on investment in the modern manufacturing sector, including both Colombian and foreign companies, to be at least 30 percent and probably as much as 40 percent per year.¹²

Other pieces of evidence suggest substantially lower profits rates, however. A survey of 41 locally owned firms in five Latin American countries concluded that after-tax net profits averaged 12.4% during 1958-62, with Argentina producing the highest return (18.3%), Chile the lowest (8.7%) and Colombia a modest 10.5%. Another questionnaire survey of 90 U.S. firms found that their expected return on Latin American investment averaged about 19%. These expected returns undoubtedly fail to include parent company profits obtained through transfer pricing, but on this point as well we cannot be sure of the transferability of the Colombian results. Studies of Australia and New Zealand found great variation between transfer prices and world market prices, but no systematic tendency for transfer prices to be higher. In the case of mineral petroleum sales by subsidiaries to parent, the tendency seems to go in the opposite direction, with transfer prices raised above world market prices, thus shifting profits toward the less developed country. Thus companies may register higher depletion allowances against tax liabilities in the United States.


14 Guy B. Meeker, "Fade-out Joint Venture: Can it work for Latin America?" Inter-American Economic Affairs, Spring 1971, p. 37. (Not clear if figures are before or after taxes.)

15 Studies by Brash and Deane cited in Vernon, op cit., p. 139.

In the age of the multinational corporation, the calculation of country specific profit rates presents difficulties for the corporation itself. It also presents a statistical challenge that the U.S. Department of Commerce has failed, at least up to the present. Furthermore, it presents a statistical and a policy challenge that Latin American countries have only recently confronted. The rough profit estimates we have presented range from 8 to 80%. Such gross divergency no doubt derives in part from error in measurement and from calculations being based on different definitions. But much of the divergence is indubitably a correct reflection of different realities, and should remind us of the dangers of generalization across heterogeneous groupings. Some, but not all, foreign investment in Latin America earns very high rates of profit. One suspects that high-yielding investment is concentrated particularly in manufacturing, where a cascading of tariffs, quantitative restrictions and exchange controls generally bestows solid monopoly positions to producers of import substitutes.

Indeed, if profit rates of say 25 percent per year were not available in Latin America, one would wonder why major North American manufacturing companies would be interested in expanding investments there. After all, the U.S. multinational corporations whose investment horizons extend to Latin America are generally high technology companies with market positions in the United States sufficiently entrenched to give assurance of solid and substantial profits. Doing business in Latin America is more complicated and riskier than in the United States, and corporations should require correspondingly higher profits. It is often suggested that corporations invest abroad for reasons of security and control more than for profits, but with few recent exceptions one has little impression that U.S. corporations are hanging on in Latin America through adverse times. Certainly that was not the impression of the Colombian government when it commissioned the Waitsos study in the first place.
BENEFIT-COST CONSIDERATIONS

While high profit rates earned by foreign companies are naturally a cause for concern, they too are a deceptive guide for evaluating the desirability of foreign investment proposals. Direct foreign investment is merely another type of investment project, and the proper way to evaluate any investment project lies with the tools of benefit cost analysis. A properly executed benefit cost analysis will give particular weight to balance of payments effects through using a shadow price for foreign exchange. Domestic resource costs would also be considered, however, each resource valued at its social opportunity cost. If benefits exceed costs when both are evaluated with correct shadow prices, discount rates, and distributional adjustments, then the project should be undertaken. And it is quite conceivable that a project providing a 100 percent return to foreign investment will nevertheless produce benefits in excess of costs.

So should the project therefore be accepted and foreign investors given such a bounty? Not necessarily, because there may be less expensive ways of getting the same project done. In the terminology of benefit cost analysis, we have here the case of mutually exclusive projects. If various projects can be undertaken to furnish the same need (e.g., hydro versus thermal power plants for supplying electricity) that project with the highest benefit cost ratio should be undertaken, and other mutually exclusive projects, even those also having benefit cost ratios in excess of one, must be passed up. In the case of direct foreign investment, various institutional arrangements for undertaking the same production facility may be considered separate projects, e.g., 100 percent foreign ownership with existing tariff structure, joint ventures with lower tariffs, domestic enterprise relying on purchased
technology, and all other possible combinations of protection, ownership shares, and tax liabilities.

Here we arrive at the policy significance of the high profit rates recorded by Vaitseos and others and the policy insignificance of statistical exercises showing that contributions of foreign investment to Latin American income or balance of payments have been positive. Such high profits strongly suggest that there existed other institutional arrangements that would have induced the same inflow of foreign investment at lower cost to Colombia, or to other Latin American countries. In this special sense profits were probably excessive and Latin America has given away too much for the foreign investment received. Such is the lesson of the transfer pricing revelations.

A BROADER FRAMEWORK OF ECONOMIC EVALUATION

Thus far, our analysis of foreign investment has taken the narrow view, considering capital the only factor thus provided to the host country and ignoring repercussions of foreign investment on households and other firms. Direct foreign investment provides a whole package of inputs, however—capital, technology, organization, and, in the case of some exports, an overseas distribution network. Since the evaluation of foreign investment proposals should oblige a country to identify the institutional arrangements by which a given output may be produced at lowest cost, alternative means for

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obtaining each of these factors must be assessed. A country should always consider the possibility that these factors will cost less when obtained separately, since when they are obtained together as direct foreign investment the foreigner rather than the national receives opportunities for monopoly profit.

Capital presents the fewest problems. It can be borrowed overseas from banks, bond markets, or international official agencies, and it can be mobilized domestically. For all the emphasis given foreign investment in Latin American development, it should not be forgotten that the bulk of savings funneled into investment in Latin American countries comes from domestic sources.

Alternative sources of supply for technology and organization are more difficult to come by. Multinational corporations exert much of their bargaining power in Latin America through control of these factors. Nevertheless, technology is also available through licensing arrangements, and organizational capability is available through both management contracts and domestic sources. While great strides have been made in recent years, it still seems fair to say that Latin America is hobbled in its dealings with representatives of direct foreign investment through ignorance of licensing arrangements and lack of capability in evaluating the alternative technologies available for licensing. Additional knowledge in these fields could pay tremendous dividends to them by opening up lower cost alternatives for given investment projects.

Managerial ability and entrepreneurship may be considered another factor of production. It is developed by experience, through learning by doing, and so the presence of foreign investment has repercussions on the rate of domestic accumulation of this crucial factor. No general statement
can be made about the direction of its effect, however. On the one hand, certain projects may be accomplished only through technology and organizational skills available to the foreigner. Then foreigners undertaking such projects would in no way diminish opportunities to domestic entrepreneurs; in fact, opportunities would be increased if the projects generated backward linkages to domestic suppliers. On the other hand, foreign investment would diminish entrepreneurship to the extent that national entrepreneurs are shut out of projects they otherwise would have undertaken. Each particular case must receive its own evaluation. Such evaluations need to be made not only by host countries, but also by scholars in pursuit of better understanding. Up to now, virtually all we have in the way of published material is intensely partisan, either totally favorable to foreign investment as in the case of May and the National Planning Association, or totally opposed to it as in the case of the CIDA studies, and the dependence literature.

**NON-ECONOMIC FACTORS IN THE EVALUATION OF FOREIGN INVESTMENT.**

The impact of foreign investment on domestic entrepreneurship is but one of several types of external effects that must be considered in

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18 Albert Hirschman argues that this negative effect has acquired increasing significance in Latin America, since national entrepreneurs are increasingly able to undertake projects formerly being done by foreigners. Cf. **How to Divest in Latin America, and Why**, Essays in International Finance No. 76, International Finance Section, Princeton University, 1969, pp. 4-9.

evaluation, even if prospects for quantifying the effects are dim. Other externalities lead us out of the realm of conventional economic accounting, into the what may be called noneconomic or psychic costs of foreign investment. Costs are no less real if they are merely psychic and nonquantifiable, however. In fact, such costs may represent the most onerous burdens placed upon Latin America by the presence of direct foreign investment.

Consider the case of a foreign investment that not only hampers the creation of new entrepreneurs in the future, but also displaces existing entrepreneurs. Those displaced may become employees in the new foreign company, at incomes equal to or greater than what they had been before. But they have lost the decisionmaking freedom of a self-employed person, and they have also lost the power and prestige that the importance of their previous position had conferred upon them. In this way, foreign investment tends to radicalize a portion of the middle class through the frustration associated with change of status, and thus to polarize the society into which it is introduced.

This process has recently been documented in the case of the large sugar haciendas on Peru's northern coast. As these foreign-owned estates expanded across the coastal valleys, they displaced numbers of medium-sized farms. The foreign concerns generally developed their own purchasing channels; they bypassed the merchants of local cities and brought ruin to many. Income per capita undoubtedly rose in the region, but so did radical politics in the form of the early APRA.

The enlightened policy of hiring nationals for managerial positions only partly alleviates the problem. In the end, the foreigners are still the bosses whose job is to give orders, and in the end this social and political situation may only be described as unstable and intolerable.

Such tensions are by no means confined to the national employees of a foreign company. Indeed, they may be far more severe outside the company, where the foreign boss becomes merely a symbol and not a person. Within the national society outside the company, the very presence of foreigners and direct foreign investment remains a continuing reminder of the meagerness of national economic achievement. The source of friction and of psychic costs lies not in the foreignness of such investment, but in its cultural distinctiveness. Far worse than being merely foreign, it is generally Anglo-Saxon, and thus generates tensions within a Latin culture that feels itself placed on the defensive.21

We return to the realm of conventional economic accounting in order to consider one final externality in the demonstration effect of consumption standards brought to Latin American countries by foreign managers and technicians. For Latin America's middle classes, this effect adds yet another inducement to higher consumption and lower saving. Therefore, in two ways, by converting entrepreneurs into bureaucrats and by raising the consumption standards of the middle classes, the presence of foreign investment is damaging to Latin America's savings rate and growth rate.

It bears emphasizing that every North American present in Latin America imposes, by his very presence, a series of psychic and economic costs. Let him ponder his role to make sure that he brings compensating virtues.
TRENDS IN LATIN AMERICAN EVALUATION OF FOREIGN INVESTMENT

These various externalities and social effects will never be quantified satisfactorily and plugged into a benefit-cost ratio. The weights implicitly applied to these factors in the evaluative process will inevitably shift about as new perceptions alter conventional wisdom. Forecasts of future trends in Latin America's evaluation of foreign investment therefore proceed from a shaky foundation. Nevertheless, we proceed.

First, it seems likely that Latin American governments will increasingly recognize that they have paid dearly for many foreign investments acquired in the past. This recognition is made most dramatic in the Vaitsos study, and will probably be reemphasized as similar studies are produced in other countries. Such high profits represent yet another unfortunate result of the uncritical and excessive pattern of tariff protection and quantitative restrictions that Latin American countries have plunged into through firm belief in the virtues of industrialization. The excessive profits obtained by foreign companies are merely one manifestation of generally high profit rates made available to monopolistic industries insulated almost completely from the pressures of world competition. Not only have these policies produced a hothouse industrialization; they have also exacerbated the already serious problems of unequal income distribution plaguing Latin America. It seems likely that in coming years programs of import liberalization and import substitution in intermediate goods industries will lower effective protection and make astronomic profit rates more difficult to come by.

Direct foreign investment will also prove less attractive as Latin American countries become increasingly able to generate lower cost alternatives.

21 It bears emphasizing, in harmony with the arguments of Schydowsky in this same volume, that some but not all Latin American industries bear the mark of hothouse efficiency.
Increased familiarity with licensing arrangements and increased knowledge of technologies available for licensing will increase Latin America's bargaining power with multinational corporations, particularly if greater competition arises among sellers of technology through development of Japanese and European technology sources. As Latin American industry acquires greater experience, its own organizational and technological capabilities will also be enhanced.  

While these various factors will tend to generate lower cost alternatives to direct foreign investment, on the other hand the perceived psychic costs of foreign investment will increase to the extent that nationalist sentiment gains further strength. One hesitates before the foolhardy task of predicting trends in nationalism, but one can certainly point to a long-run increase in nationalist, anti-foreign-business sentiment that has been running throughout the present century. Moreover, the experience of the 1960s seems to have been no exception to this trend.

On the other hand, there exist some factors making direct foreign investment more attractive. In some sectors the technology gap may be widening. Although Latin American organizational and technological capabilities may be improving, the multinational corporation's capabilities may be improving, the multinational corporation's capabilities may be improving at a faster rate. In such sectors, Latin American countries will be in a weak bargaining position and must either take foreign investment pretty much on its own terms or give up on production possibilities and import. As the process of import substitution becomes less uncritical during the 1970s, the alternative of importing may be resorted to increasingly.

Another factor favoring direct foreign investment concerns the export of manufactures. Exports of traditional primary products will continue to play  

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their essential role in earning foreign exchange, but new exports, many
of them manufactures, must be relied on for an increasing share of total
dollar earnings. Brazil, Mexico, and Colombia have demonstrated in recent
years that appropriate exchange rate policies can do much to encourage
manufactured exports, and that foreign companies will be particularly active
in this new export trade. The wholly owned subsidiary of the multinational
corporation may be a particularly advantageous form for export development.
It has the world-wide distribution network of the multinational corporation
available to funnel its products to distant markets, and the multinational
corporation would have no incentive to discriminate against it in decisions
regarding choice of production facility for serving a third country's market.
The situation would be different for a joint venture, since the multinational
corporation would obtain only a fraction of the profits earned by its exports,
whereas it would earn all the profits if the same sales opportunity were served by
other plants within the corporation's production network. 23

The question of export performance is but one of several reservations
that may be raised about joint ventures as the institutional solution to
Latin America's foreign investment problem. Compared to wholly owned
subsidiaries, joint ventures seem generally to make higher payments to the foreign
partner for technical services and capitalized technical knowledge, thus adding
to the host country's costs. 24 However, they also present distinct advantages,
since the partial transfer of control to local partners may be expected to
reduce transfer prices for purchased inputs and to diminish psychic costs of a
foreign presence.

23 For an illuminating discussion of the prospects for joint ventures, see
Louis T. Wells, Jr., "Foreign Investment in Joint Ventures: Some Effects of
No. 167, Development Advisory Service, Harvard University, 1970 (mimeo).
For these reasons, it seems likely that joint ventures, including the fade-out variety, will be experimented with increasingly, even though the rather rigid fade-out formula embodied in Decision 24 of the Andean Group hardly seems the final word in the search for new institutional arrangements. In some cases, investments that might be judged socially useful, e.g., labor-intensive assembly plants that re-export back to the United States, may be available only on a 100% foreign basis. In other cases, the social purpose of a joint venture may become corrupted by local partners who merely go along for the ride, leaving all decisions to the foreigners and making no effort to perform a watchdog function. Therefore, we may expect the key words of Latin American policy in the next decade to be flexibility and control. Despite the dangers of corrupting traditionally weak bureaucracies by endowing them with discretionary powers, a flexible approach will probably prove imperative as various combinations of joint ventures, production contracts and special controls over wholly owned subsidiaries prove most suitable in different cases. The constant objective sought by these various institutional arrangements will surely be greater national control over foreign investment.

New institutions and greater control should cut down opportunities for foreign companies to earn excessive profits. At the same time, returns will undoubtedly be cut below minimum levels required by certain foreign companies, and the flow of new investment will be reduced accordingly. This development will hurt growth rates, but it must be accepted as a price to be paid for the rapid social change experienced in some parts of Latin America and desired everywhere in Latin America. Rapid social change may well increase

risk to foreign investors and induce them to raise their minimum required profits rates to levels judged by Latin American governments to be unacceptable.

Although growth targets may suffer, quite possibly social welfare will be increased by stringent controls on foreign investment even at the price of some growth. To state the obvious only because it is occasionally forgotten, the objective of economic policy lies in maximizing social welfare, not GNP.

Finally we may expect the lively social concern over foreign investment to have effect in statistical reporting and in the explicit setting of social goals. Only ten years ago, for example, the only source available to the Peruvian government regarding the extent of foreign investment in Peru was the U.S. Embassy. Ten years hence, we may expect that effective reporting systems on all types of foreign indebtedness, especially direct foreign ownership of capital, will be operative in Peru and elsewhere. Furthermore, I think we can anticipate the day when regularly produced reports on the stock of foreign-owned capital are given the public attention that reports on GNP receive today, when a decrease in the level of foreign capital is viewed as a measure of social progress in the same way that we now view an increase in the level of GNP.