Foreign Direct Investment in a Small Open Economy and Global Trade Liberalization in Agriculture: A Note

Sarbajit Chaudhuri
University of Calcutta

Abstract

In a production structure reasonable for a developing economy this note shows that there may arise a conflict between the worldwide liberalized trade policies in agriculture, which raise the price of the economy’s primary exportable commodity, and the inflow of foreign capital into the economy. However, if the economy strictly adheres to the different facets of the agricultural trade liberalization policies, e.g. the removal of the indirect farm subsidies, the paper argues that the possible conflict may be avoided. The paper provides a theoretical basis for the removal of the farm subsidies if the economy wants to develop its technologically more advanced sectors with an adequate supply of foreign capital.

• JEL Classifications: F10, F13, O19.

• Key words: Liberalized trade policy in agriculture, Foreign capital inflow, Rate of return on foreign capital, Fertilizer subsidy

I. Introduction

Foreign capital plays a prominent role in the development of developing countries. The inflow of foreign capital not only can help in lessening the scarcity of domestic capital but also can help in transferring improved technology of production to the host countries, boosting up of the economy’s
export growth and hence improving the balance-of-payments position and generating additional employment opportunities utilizing the hitherto untapped local resources. Of the different types of foreign capital our focus in this paper will be on the foreign direct investment (FDI), which is generally sector-specific in nature. Multinational corporations (MNCs) are no benevolent institutions. They invest only with an eye to the profitability of investment in the sector in which they plan to invest. Naturally they are interested to invest in the technologically advanced sectors with high profitability. Several studies have pointed out that over the last decade or so the FDI to developing countries has increased considerably.

The multilateral agreement and the formation of the World Trade Organization (WTO), resultant of the Uruguay round of discussions, have brought about revolutionary changes in liberalizing international trade across countries whether developed or developing. Radical measures for reducing tariff barriers and completely doing away with non-tariff barriers to ensure freer global trade have already been undertaken in manufacturing commodities that are intensive in the use of capital or skilled labour. However, the attempt to subject agricultural commodities to disciplines similar to those that govern trade in manufactures has not so far been successful. Moreover, in agriculture, exports from developing countries remain severely hampered by massive domestic support and export subsidy programs in developed countries, by peak tariffs and difficulties in the implementation of the tariff quota system (UNCTAD, 1999, p 41).

The possibility of a conflict between tariff reforms in manufactures and the attraction of foreign capital in a developing economy is inevitable. It has been observed that some developing countries, notably the non-OECD countries, are relatively slow in carrying out tariff reforms compared to other countries, although they have opted for the policy of free trade as their development strategy and have been able to attract substantial amount of Foreign Direct Investment (FDI) during the last decade. The explanation is provided by the tariff-jumping theory\(^1\) that suggests a positive correlation between the amount of FDI in a country and the tariff rates imposed by it. There is no doubt that the major driving force behind FDI by the multinational corporations (MNCs) in the developing countries is the higher rate of return on their capital in these

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\(^1\)See for example, Motta (1992) and Yanagawa (1990) for details.